

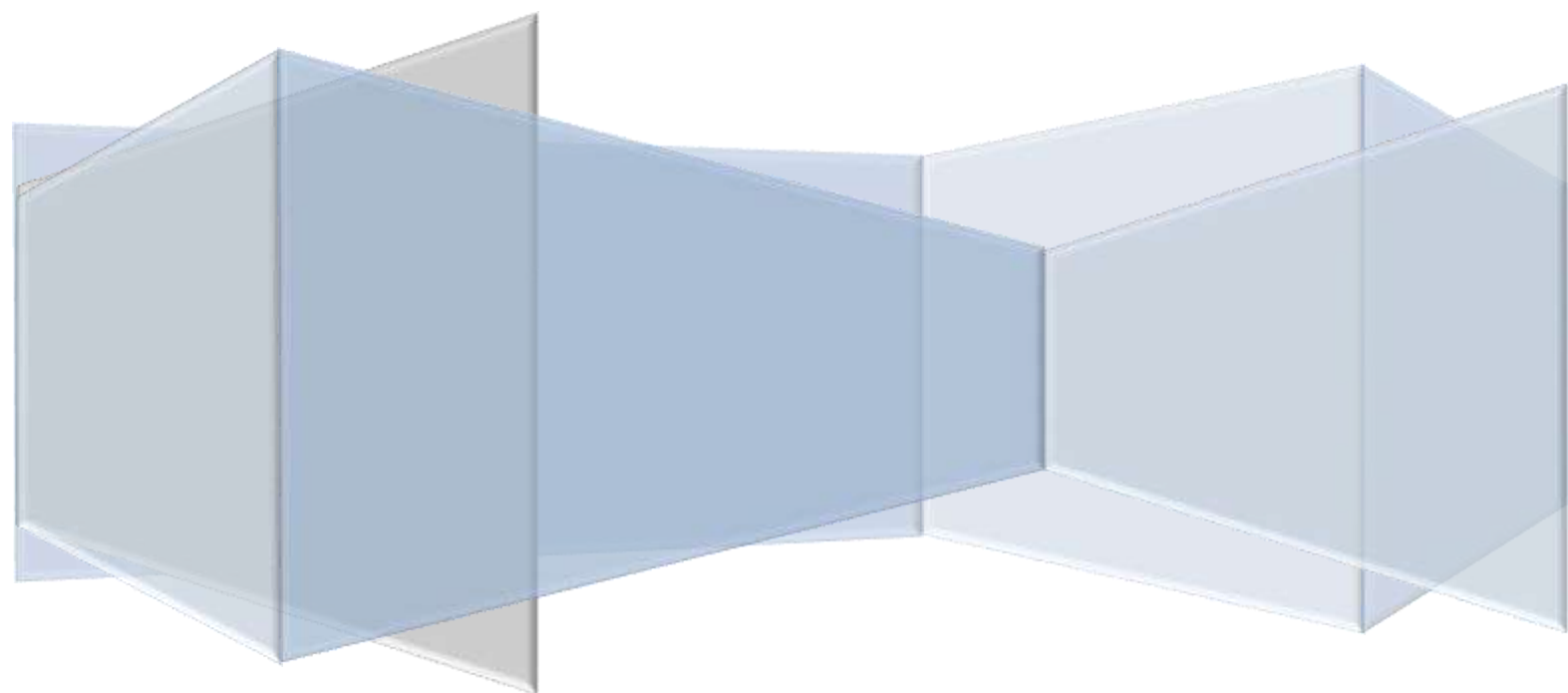
MFSA

MALTA FINANCIAL SERVICES AUTHORITY

GUIDANCE NOTES ON THE APPLICATION OF THE PROPORTIONALITY PRINCIPLE IN RELATION TO THE ESMA GUIDELINES ON SOUND REMUNERATION POLICIES UNDER THE UCITS DIRECTIVE AND THE AIFMD

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I. Introduction

1. Article 13, Article 22(2)(e) and (f) and Annex II of the [AIFM Directive](#) introduce remuneration provisions with the aim of ensuring that remuneration and incentive structures in AIFMs (and self-managed AIFs) do not induce excessive risk-taking and are disclosed appropriately. Similar provisions have also been introduced with the coming into force of the [UCITS V Directive](#) which regulates remuneration in Articles 14a and 14b applicable to UCITS Management Companies (and self-managed UCITS).¹
2. These Guidance Notes present the MFSA's views on how proportionality should be taken into account by UCITS Management Companies and AIFMs when designing their remuneration policy based on the principles outlined in the UCITS Directive and the AIFMD and as further explained in the [Guidelines on Sound Remuneration under the UCITS Directive \[ESMA/2016/575\]](#) ("the UCITS Remuneration Guidelines") and the [Guidelines on Sound Remuneration under the AIFMD \[ESMA/2016/579\]](#) ("the AIFMD Remuneration Guidelines")². These Guidance Notes should be read in conjunction with the applicable provisions of the MFSA Rulebooks relating to remuneration.³
3. The [Guidance to the financial services industry on the application of the proportionality principle in relation to the ESMA guidelines on sound remuneration policies under the Alternative Investment Fund Managers Directive](#) issued by the MFSA on 28 March 2014 is being repealed with immediate effect.
4. The MFSA intends to keep these Guidance Notes under review, and may carry out revisions further to developments at EU level⁴ or following receipt of additional information on the organisation and activities of licensed UCITS Management Companies and AIFMs.

¹ Unless otherwise specified, reference to an AIFM and a UCITS Management Company in these Guidance Notes includes a self-managed AIF and a self-managed UCITS respectively.

² The AIFMD Remuneration Guidelines amend the *Guidelines on sound remuneration policies under the AIFMD [ESMA/2013/232]* published on 11 February 2013.

³ Further details are outlined in the *Circular on the implementation of the ESMA Guidelines on sound remuneration policies under the UCITS Directive and the AIFMD* dated 30 January 2016.

⁴ On 31 March 2016 ESMA has written to the European Commission, European Council and European Parliament calling for further clarity and alignment of the proportionality principle and remuneration rules across the financial sector.

Applicability

5. The MFSA has developed these Guidance Notes based on recent regulatory developments on the topic and the experience learnt since the implementation of the original [AIFMD Remuneration Guidelines \[ESMA/2013/232\]](#). In particular it has applied the following key principles:
- (a) It is the intention of the MFSA to comply with the UCITS Remuneration Guidelines and the AIFMD Remuneration Guidelines (“the ESMA Remuneration Guidelines”) in their entirety, including the rules applicable to delegates.
 - (b) Given the strong convergence in the provisions of the UCITS Remuneration Guidelines and the AIFMD Remuneration Guidelines, the MFSA decided to develop a common framework based on which proportionality could be assessed by both a UCITS Management Company and an AIFM. This would also facilitate the process for licence holders with a dual authorisation.⁵
 - (c) It is the ultimate responsibility of the UCITS Management Company/ AIFM to carry out the proportionality test comprehensively and document it appropriately. The licence holder should be able to demonstrate at any time, with supporting evidence, the way in which it has applied the relevant remuneration principles.

⁵ Recital 9 of the UCITS V Directive states that ESMA should draft guidelines on remuneration policies and practices, which are where appropriate, aligned, to the extent possible, with the equivalent guidelines under the AIFMD as well as 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.

The overwhelming majority of respondents to the consultation paper issued by ESMA on the UCITS Remuneration Guidelines supported an approach to proportionality which is in line with the AIFMD Remuneration Guidelines.

II. Proportionality

6. Proportionality in the application of remuneration principles is recognised in the legislative texts and has been reflected in the ESMA Remuneration Guidelines. The latter highlight that provisions should enable a UCITS Management Company/AIFM to take a proportionate approach to compliance with a remuneration principle in a way and to the extent that is appropriate to the:
 - (a) size of the UCITS Management Company/AIFM and of the UCITS/AIFs it manages;
 - (b) its internal organization; and
 - (c) the nature, scope and complexity of its activities⁶.
7. The UCITS Management Company/AIFM must consider the cumulative presence of all factors when applying the proportionality test and thereby assessing whether and to what extent the remuneration principles should be applied.
8. Both the UCITS Directive and the AIFMD prescribe that proportionality is a key element that shall apply to the full set of remuneration principles set out under these Directives.⁷

Complete Disapplication of Principles on Remuneration

9. The AIFMD Remuneration Guidelines provide that proportionality may lead, on an exceptional basis and taking into account specific facts, to the disapplication of some requirements if this is reconcilable with the risk profile, risk appetite and the strategy of the AIFM and the AIFs it manages and within the limits set by the same guidelines.
10. In line with the AIFMD Remuneration Guidelines, the only provisions that can be completely disapplied for an AIFM's total identified staff, or for some categories within its identified staff, in line with the proportionality principle are⁸:

⁶ Refer to Point 29 of the AIFMD Remuneration Guidelines and Point 25 of the UCITS Remuneration Guidelines.

⁷ The remuneration principles are highlighted through letters (a) to (r) of Annex II of the AIFM Directive and letters (a) to (r) of Article 14b(1) of the UCITS V Directive.

⁸ Refer to Point 26 of the AIFMD Remuneration Guidelines.

- i. The requirements on the pay-out process, namely:
 - (a) Variable remuneration in instruments (minimum portion of 50% of variable remuneration should be paid in instruments in accordance with Annex II, paragraph 1(m) of the AIFMD),
 - (b) Retention (the AIFM must determine a retention policy which should explain its relation to other risk alignment measures in the total remuneration policy and whether and how the AIFM differentiates between instruments paid up-front and deferred instruments),
 - (c) Deferral (variable remuneration to be withheld for a minimum of three to five years following the end of the period during which performance of the staff member is assessed and measured for the purposes of determining its remuneration; and minimum portion of 40% to 60% of variable remuneration should be deferred, in accordance with Annex II, paragraph 1(n) of the AIFMD),
 - (d) Ex-post incorporation of risk for variable remuneration; and
- ii. The requirement to establish a remuneration committee.

- 11. The UCITS Remuneration Guidelines are silent in relation to whether there could be a complete disapplication from the requirements on the payout process and/ or the requirement to establish a remuneration committee and/ or any other requirements based on proportionality.
- 12. The MFSA sees merit in allowing the requirements on the payout process and the establishing of a remuneration committee to be disapplied on the basis of proportionality. It should also be possible for the requirements on the payout process and/ or the remuneration committee to be disapplied under the UCITS Remuneration Guidelines.⁹
- 13. Disapplication in both scenarios is never automatic and licence holders must be able to explain to the MFSA how they consider it appropriate for certain principles to be disapplied.

⁹ The MFSA considers that the different nature of UCITS and AIFs compared to credit institutions and the relatively diverse nature of the funds sector, could justify a different approach to proportionality than the one in the *EBA Guidelines on sound remuneration policies under CRD IV* which does not permit exemptions or waivers to the application of the proportionality principles.

In its letter to the European Institutions, ESMA indicated that the disapplication of pay-out process requirements should remain possible in certain situations. The MFSA has followed the approach which is consistent with the AIFMD remuneration guidelines in the absence of further legal clarity on this possibility.

14. In addition:

- When a licence holder (based on the proportionality test) is able to completely disapply the requirements on the payout process and/or the remuneration committee it may still in its discretion apply these requirements as a matter of best practice as long as the numerical criteria included in the ESMA Remuneration Guidelines are adhered to. In this case, the AIFM may also apply (or disapply) the rules on the pay-out process in their entirety for its total identified staff or with respect to particular identified staff.
- When a licence holder (based on the proportionality test) is not able to disapply these requirements, it must adhere to the requirements as indicated in the ESMA Remuneration Guidelines in their totality including the numerical criteria provided therein.¹⁰

Proportionate Application of Principles on Remuneration

15. The MFSA acknowledges that proportionality may be applied to all the principles outlined in Annex II of the AIFMD/ Article 14b of the UCITS Directive as further explained through the ESMA Remuneration Guidelines. Therefore it is possible that when justified by size, internal organisation and nature, scope and complexity of its activities an AIFM or UCITS Management Company may adopt a tailored implementation to any of the prescribed remuneration principles which best aligns the interests of the fund managers with those of the investors of the funds they manage e.g. on disclosure.

¹⁰ In its letter to the European Institutions, ESMA indicated that applying lower thresholds whenever minimum quantitative thresholds are set should remain possible in certain situations. The MFSA has followed the approach which is consistent with the AIFMD remuneration guidelines in the absence of further legal clarity on this possibility.

III. The Proportionality Test

16. AIFMs and UCITS Management Companies should apply the proportionality test to establish their level of significance. This Section gives more detail on the proportionality test, citing examples of elements that the licence holder can take into account in this test and how its outcome will impact the implementation of the principles explained in the ESMA Remuneration Guidelines.
17. If, after carrying out the proportionality test, the licence holder concludes that it is not significant in terms of size, internal organisation and nature, scope and complexity of its activities, then it may apply a degree of proportionality to the remuneration principles. This could result in certain rules in the ESMA Remuneration Guidelines being entirely disapplied (in the case of the requirements on the payout process and/or the requirement to establish a remuneration committee) or applied to a proportionate extent.
18. However, if the licence holder is significant in terms of size, internal organisation and nature, scope and complexity of its activities, a full application of the remuneration principles applies. It is also recognised that there could be instances where one should apply these principles to a more sophisticated extent than as provided in the ESMA Remuneration Guidelines.
19. These Guidance Notes outline a non-exhaustive list of elements that can assist the licence holder in determining its significance and consequently in implementing the principles on remuneration.

Size

20. In relation to size, the MFSA has established different thresholds to be calculated on the basis of the value of the portfolio of UCITS/AIFs managed by UCITS Management Companies/AIFMs¹¹ and based on the limited numerical guidance found in the ESMA Remuneration Guidelines.
21. The MFSA has established different thresholds for UCITS Management Companies/AIFMs whose portfolio of UCITS/AIFs includes assets acquired through the use of leverage and UCITS Management Companies/AIFMs whose portfolio of AIFs does not include leveraged assets.

¹¹ For the purpose of this determination, the value of the portfolios managed shall be the sum of the absolute value of all assets of all UCITS/AIFs managed by the UCITS Management Company/AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value.

22. The following table illustrates these thresholds and the proportionate treatment of the relevant remuneration principles:

LEVERAGED ASSETS

Criteria	Pay-Out Process Rules	Remuneration Committee
Value of the Portfolios less than EUR1.25 billion	Disapplication may be considered on the grounds of proportionality	Disapplication may be considered on the grounds of proportionality
Value of the Portfolios more than EUR1.25 billion	Full application	Full application

UNLEVERAGED ASSETS

Criteria	Pay-Out Process Rules	Remuneration Committee
Value of the Portfolios less than EUR6 billion	Disapplication may be considered on the grounds of proportionality	Disapplication may be considered on the grounds of proportionality
Value of the Portfolios more than EUR6 billion	Full application	Full application

23. The value of the portfolios alone provides a reasonable starting point as to how considerations of proportionality should be reflected in the UCITS Management Company/AIFM's remuneration policy. However, other factors should be taken into account that may alter this position.

24. Based on the position derived from the thresholds, the MFSA would expect the licence holder to consider other proportionality elements in relation to the size factor, for example:

✓ the number of the UCITS Management Company/AIFM's employees may increase the level of significance determined in terms of the value of the portfolios.

25. If, after considering additional elements on size, the UCITS Management Company/AIFM still considers that it qualifies for the original classification of significance based on the value of the portfolios it should proceed to assess its internal organisation. On the contrary, if these elements alter the original position, then this should be reflected by incorporating additional elements in the application of the remuneration principle.

Internal Organisation

26. The internal organisation criterion can relate to:

- the UCITS Management Company/AIFM's legal structure and that of the AIFs/UCITS they manage;
- the complexity of the internal governance structure of the UCITS Management Company/AIFM; and
- the listing on regulated markets of the UCITS Management Company/AIFM or the UCITS/AIFs it manages.

27. Starting from the position derived from the thresholds, the MFSA would expect the licence holder to consider other proportionality elements in relation to its internal organisation, for example:

- ✓ whether the UCITS Management Company/AIFM is listed and traded on a regulated market may increase the impact of significance determined in terms of the value of the portfolios.

28. If, after considering these additional elements on internal organisation, the UCITS Management Company/AIFM still considers that it qualifies for the original classification of significance in terms of the value of portfolios it should proceed to assess its [nature, scope and complexity](#). On the contrary, if these elements alter the original position, then this should be reflected by incorporating additional elements in the application of the remuneration principle.

Nature, Scope and Complexity

29. The nature, scope and complexity criterion can relate to:

- the type of authorized activity;
- the type of investment policies and strategies of the AIFs/UCITS that the AIFM/ UCITS Management Company manages;
- the national or cross-border nature of the business activities; and
- the additional management of UCITS/AIFs.

30. Starting from the position derived from the thresholds, the MFSA would expect the licence holder to consider other proportionality elements in relation to its nature, scope and complexity, for example:

- ✓ the extent to which a UCITS Management Company/AIFM manages a large number of UCITS/AIFs which implement a wide range of strategies, is likely to increase complexity and may increase the impact of significance determined in terms of the value of the portfolios.
 - ✓ the extent to which a UCITS Management Company/AIFM and/or the UCITS/AIFs it manages, is systemically important or leads to complex investment management activities, may increase the level of significance determined in terms of the value of the portfolios.
31. If, after considering these additional elements on the nature, scope and complexity, the UCITS Management Company/AIFM still considers that it qualifies for the original classification of significance in terms of the value of portfolios it could conclude that the original classification is justified. If these elements alter the original position, then this should be reflected by incorporating additional elements in the application of the remuneration principle.

Initial Assessment and Ongoing Monitoring

32. In terms of the ESMA Remuneration Guidelines, the implementation of the remuneration policy has, at least annually, to be subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function.

With regards to any requests for derogations in relation to the pay-out process and/ or the remuneration committee requirements, the licence holder should undertake the proportionality assessment and submit it for the MFSA's consideration, indicating how the derogation would be appropriate in terms of its size, internal organisation, nature, scale and complexity.

33. Licence holders applying a derogation should resubmit the results of the proportionality assessment at least every two years (from the date of issue of the derogation from such requirements). This assessment needs to indicate how such derogations are still appropriate or otherwise for the licence holder.

34. The following information on the UCITS Management Company/ AIFM needs to be submitted to the Authority to support any requests for derogations or updates thereto:

Assets under Management

The value of the portfolios managed in accordance with Paragraph 22 of these Guidance Notes.

Staff

The number of employees employed by the UCITS Management Company/ AIFM and a brief description of the job accountabilities for each employee.

Group entities

The number of branches and/ or subsidiaries and their domicile.

Organisational structure

A detailed organogram setting out all reporting lines.

Listing status

Whether the UCITS Management Company/ AIFM is listed on a trading venue(s). If so, details of the trading venue(s).

Derivatives

For each UCITS/AIF managed, the extent of use (if any) of derivatives in terms of the prospectus; whether derivatives are used for hedging purposes or for investment purposes, or for both.

Strategies

For each UCITS/AIF managed, brief details of the investment strategy employed in terms of the prospectus.

Cross-border activities

Brief description of any passporting activities in terms of the UCITS Directive and the AIFMD, indicating key business volumes relating to these activities.

All requests for derogations should be submitted to funds@mfsa.com.mt. It is essential that all requests cover, as a minimum, the above points. Where any point is not applicable this should be marked accordingly.

IV. Application of Rules to Delegates

35. When a UCITS Management Company or AIFM delegates any functions of portfolio management or risk management in should ensure that either:
- (a) delegation is carried out to entities which are subject to regulatory requirements on remuneration that are equally as effective as those under these guidelines; or
 - (b) appropriate contractual arrangements are put in place to ensure there is no circumvention of the remuneration rules.

Equally Effective Regulatory Requirements

36. The MFSA is of the view that an entity can be considered subject to regulatory requirements on remuneration that are equally as effective as those applicable under these guidelines, inter alia, where the following conditions are met:
- i) the entity with whom the delegation arrangement is concluded is subject to the remuneration rules under either the AIFMD or the UCITS V Directive or the [CRD IV Directive](#), and
 - ii) the staff of the entity who are identified staff for the purpose of these guidelines are subject to AIFMD or UCITS or CRD IV rules.
37. These criteria acknowledge the potential outreach of the Capital Requirements Directive rules and are also reflected in the AIFMD Q&A¹² issued by ESMA as well as directly referred to in the UCITS Remuneration Guidelines.
38. Moreover, delegation arrangements with entities subject to remuneration rules under [MiFID](#) are also considered favourably by the MFSA in determining equally effective remuneration requirements.
39. In the absence of such arrangements, the UCITS Management Company/AIFM must ensure that appropriate contractual arrangements are put in place to ensure there is no circumvention of the remuneration rules. It would need to ensure that it holds evidence of the analysis carried out. This analysis should be kept for compliance purposes and may be subject to MFSA's review during onsite visits.

¹² The ESMA AIFMD Q&A dated 16 November 2016 states that "Provided that the staff of these entities who are identified staff for the purpose of the Remuneration Guidelines are subject to the CRD rules, these entities are subject to regulatory requirements on remuneration that are equally as effective as those applicable under the Guidelines."

Proportionality and Delegation

40. The ESMA Remuneration Guidelines specify that the remuneration requirements apply to delegates of the UCITS Management Company/AIFM. This is the case even when the delegate's contract with the UCITS Management Company/AIFM sets out strict investment guidelines or covers only a small portion of the portfolio.
41. Proportionality, when justified in terms of size, internal organisation and nature, scope and complexity of its activities may also be applied in the context of delegation.
42. In light of the above, there might be cases where the full application of the relevant remuneration principle to the delegate itself or the staff of the delegate (e.g. payout process rules and/or the remuneration committee) would not be proportionate and would not achieve the outcome of aligning the delegates' staff interests with those of the investors in the UCITS/AIFs.

V. Transitional Provisions

43. Existing licence holders within scope of the ESMA Remuneration Guidelines should reassess their remuneration setups in line with the contents of these Guidance Notes. These licence holders should apply remuneration principles in line with the contents of these Guidance Notes by **30 June 2017**.
44. In particular, they should examine; (i) whether the proportionality assessment takes into account the cumulative presence of all factors (i.e. size, internal organisation, nature, scale and complexity; (ii) how each remuneration principle will be applied in view of the proportionality assessment (i.e. fully applied, fully disappplied, proportionately applied).