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The Advent of Investment Adviser Remuneration Regulation

by Stuart Fross and Philip Morgan

Remuneration practices of *employees* of investment advisers registered with the Securities and Exchange Commission (the SEC) under the Investment Advisers Act of 1940, as amended (the Advisers Act) has received limited regulatory attention in the United States.[1] To date, no employee compensation of investment adviser employees is subject to regulation or supervision. This is about to change for certain investment advisers, potentially signaling the leading edge of a global regulatory trend that may come to affect investment advisers and their key employees more broadly.[2]

Generally, a new global focus on risk management has suggested that not only should certain investment adviser *employee* remuneration be considered as part of a risk management process, but that some forms of remuneration should be *precluded* by regulation, even in the context of private funds, hedge funds and private equity funds sold to institutional investors. This is a new trend that could profoundly influence the business models of investment adviser firms if, over time,

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the application of emerging remuneration regulation is taken up more broadly. Initially, the three drivers of this trend can be identified: the G-20, regulations adopted within the European Union, and rulemaking in response to the Dodd Frank Act in the United States,[3] each of which will be considered in turn below.

I. Supervision of Remuneration Practices as Part of a Global Regulatory Strategy

The response to the financial crisis of 2008 continues to play out on a multi-national level, if not led, then seemingly influenced by the G-20 process.[4] The G-20, to a remarkable degree, has seemingly taken a policy making lead.[5] The G-20 has made remuneration (including remuneration of investment advisers) a significant focus of global efforts to recalibrate the world's financial system. Starting in 2009, acting at the direction of the G-20, the Financial Stability Board[6] (the FSB) stated that compensation practices in use by financial institutions was "one factor that contributed" to the 2007 global financial crisis and called upon each financial services center to be "speedy, determined and coherent" in regulating and supervising remuneration. Specifically, the FSB described remuneration within financial services firms as "largely unrelated to risk management." The FSB observed that leading up to the crisis, remuneration practices were not linked to risk management and that risk takers therefore had an incentive to evade risk management. The FSB observed that "this must change." To this point, the FSB stated that effecting change would require regulation and supervision on a "rigorous and sustained basis."[7]

Evidently, for some investment advisers some of the time, the firm will soon lose control over its compensation plan (to some degree) to its regulators. By way of background, the FSB established its remuneration guidance in two stages.[8] In April 2009, FSB issued a statement of principles. While these principles provided guidance on *why* and *how* remuneration should be addressed, the Sound Compensation Principles offered no details that could actually be implemented into regulatory or supervisory standards, or into a pay package. Thus, the broad principles of April 2009 were followed in September 2009 with the FSB's "implementation standards" (the Implementation Principles). Drawing directly from the Sound Compensation principles, the Implementation Principles focused on various aspects of remuneration practices: "governance" (which focused primarily on the role of the board of directors' compensation and risk committees within financial services firms); "compensation and capital" (which focused on preventing compensation from eroding regulatory capital); "disclosure" (which focused on reporting by financial services companies that are public companies); "supervisory oversight" (which focused on corrective action by the relevant regulator); and, most importantly for the purposes of this paper "pay structure and risk alignment" (to be discussed in more detail below).

The provisions on "pay structure and risk alignment" have proven quite influential, permeating various pending rule making initiatives pertinent to investment advisers and to collective investment schemes in the United States and Europe. Accordingly, they merit some review by investment advisers, even if they are now more than six months old.

Under the Implementation Principles, remuneration for senior management and for "other employees that have a material impact on the risk exposure" of the firm should be regulated and restricted. Within an investment adviser, the Implementation Principles appear to apply to directors and executive officers, portfolio managers, traders, risk managers, and compliance officers, and potentially other persons whose position materially affects risk exposure (Covered Employees).

The firm's performance should affect individual compensation for Covered Employees (thus potentially reducing variable compensation for portfolio managers and traders whose products have performed well if the firm's overall performance should be negative or "subdued"). For Covered Employees, a significant portion of their compensation should be variable and should be measured against individual, business unit and firm wide goals. Between 40 and 60 percent of variable compensation should be unvested and deferred for a term

of years. Very senior employees should have more than 60 percent deferred and unvested. The deferral and vesting period should be at least three years, and vesting should be no faster than pro-rata. Unvested portions should be subject to claw-backs tied to business unit and firm performance in subsequent periods. A substantial proportion of variable compensation should be share linked. Except in hiring of new staff, bonus guarantees are to be prohibited as "not consistent with sound risk management" and therefore guaranteed bonuses should not be "part of prospective compensation plans."[9] Financial institutions must demand that their Covered Employees not utilize hedging strategies that would "undermine the risk alignment effects imbedded in their compensation plans," and accordingly, compliance mechanisms related to personal investments must be adopted to this purpose.

II. Two Narrow Escapes: Regulation of Remuneration Practices of Investment Advisers in Europe Under CRD III, and the US Joint Agency Statement

Proportionality and Investment Manager Remuneration. On July 7, 2010, the European Parliament adopted amendments to the EU's Capital Requirements Directive (CRD III),[10] including new rules regarding remuneration policies at EU credit institutions and at firms incorporated or formed in the European Economic Area that fall within the scope of the EU's Markets in Financial Instruments Directive (MiFID), currently including most EU-based investment advisers, fund managers and broker-dealers. Regulated EU-based subsidiaries of non-EU credit institutions, investment managers and brokers will typically be within the scope of the new rules. These rules are now in effect and affect bonuses paid from January 1, 2011 onward (including bonuses relating to the 2010 financial year or prior years).[11]

At a national level, in December 2010, the UK's Financial Services Authority (FSA) published the final text of its revised Code of Practice on remuneration. The Code applies from January 1, 2011 onwards to all FSA-regulated banks, building societies and investment firms that fall within the scope of the MiFID, including most investment advisers and fund managers (including branches and subsidiaries of Non-EU firms).[12] (It does not apply to UCITS management companies, with respect to which remuneration is being taken up under UCITS V, as will be discussed below).[13]

Although the Code has significant implications for financial services firms, its impact on discretionary investment managers is mitigated significantly by the "proportionality principle" introduced through CRD III and adopted by the FSA. The proportionality principle suggests that the level of mandatory compliance with the Remuneration Principles can be adjusted by the nature of the particular financial services firm's activities, and the degree to which the firm's risk taking might affect its capital. To this end, the FSA created a framework of four tiers of financial services firms and specified a different level of expected compliance for each tier. Broadly speaking, tiers 1 and 2 will apply to the larger banks, building societies and broker dealers. Tiers 3 and 4 apply to investment firms and fund managers. Stand alone discretionary investment managers (as contrasted to firms with multiple authorizations) typically are "tier 4 firms."[14] Tier 4 contains "limited license" firms and "limited activity" firms that generate income from agency business without putting their balance sheets at risk.[15] These firms are generally able (subject to proportionality) to disapply the rules regarding the deferral of variable awards, the requirement to fix a maximum ratio between fixed and variable remuneration, the retention of equity awards, the malus/clawback of deferred awards, and the requirement to establish a remuneration committee. They can also take into account the specific features of their types of activities when considering the requirement to assess performance in a multi-year framework and in particular the accrual and performance-related adjustment elements of making awards.

Firms within the scope of the Code will be required to report to the FSA on compliance with the Code, and they will also be required to make public disclosures regarding their

remuneration policies.[16] The reporting and disclosure requirements are being implemented taking into account "proportionality" principles so that larger firms have greater reporting and disclosure requirements. All in scope firms will be required to make public disclosure regarding their remuneration policies at least in respect of: corporate governance relating to remuneration policy; information on the link between pay and performance; and aggregate quantitive information on remuneration, broken down by (i) business area and (ii) senior management and members of staff whose actions have a material impact on the firm's risk profile.[17]

In light of the ability of Tier 4 firms to disapply the more proscriptive of the Implementation Principles, for the time being, "investment managers" acting with investment discretion in the UK have not been subjected to the full burden of the FSB's guidance on remuneration practices, except for reporting to the FSA on compliance with the Code.

III. Regulation of Fund Manager Remuneration: AIFMD and UCITS V

On November 11, 2010, the European Parliament of the European Union (the EU) approved the "Proposal for a Directive of the European Parliament and of the Council on Alternative Investment Fund Managers" (the AIFM Directive).[18] First proposed in April 2009 in response to the financial crises, the AIFM Directive seeks to provide a harmonized EU regulatory framework for the supervision and operation of alternative investment fund managers (Managers) and is expected to have far-reaching consequences for the fund industry both in the EU and elsewhere.

The AIFM Directive will apply to: (i) Managers with a registered office in the EU (EU Managers); and (ii) all other Managers (Non-EU Managers) that manage and/or market alternative investment funds (Alternative Funds) in the EU. For purposes of the AIFM Directive, "Alternative Funds" include hedge funds, private equity funds, real estate funds, infrastructure funds, mutual funds domiciled and registered in the United States, and all other collective investment undertakings that are not compliant with the EU Undertakings for Collective Investments in Transferable Securities UCITS Directive. The AIFM Directive has been the subject of extensive commentary, and we limit our remarks here to the remuneration provisions.

When the AIFM Directive enters into force (which is expected to be in June or July of 2011 depending on the publication date of the AIFM Directive in the Official Journal of the European Union), it will not have any immediate effect on Managers. The AIFM Directive will be binding only on the Member States, which, within two years, will be required to adopt laws that will implement the AIFM Directive's requirements at the national level.

Remuneration and risk management are central tenets of the AIFM Directive, which contemplates controls applicable to remuneration paid to senior management, risk takers and control functions.[19] Article 13 is devoted to remuneration and requires that member states mandate that Managers have policies and procedures designed to promote "sound and effective risk management" that do not encourage risk taking that is excessive given the nature of each fund managed by the Manager. The fund's annual report to shareholders will include remuneration disclosure as to amounts paid and the proportion of which is fixed or variable. Annex II of the AIFM Directive provides detailed requirements for compensation plans for AIFM key employees that are substantively similar to those found in the FSB's Implementation Principles, discussed above. Annex II imposes the following requirements for fund Manager compensation policies and procedures:

It is required that the Manager's remuneration policy observe the following:

(a) Promotes sound risk management;
(b) Is in line with fund's objectives and avoids conflicts of interest;
(c) Is reviewed periodically by directors of the management company;
(d) Implementation is subject to annual compliance review;
(e) Insulates staff of control functions from business units;
(f) Provides that risk and compliance com-

pensation is determined by a compensation committee;
(g) Takes into consideration individual, business unit and firm results performance compensation awards;
(h) Sets performance awards in a multi-year framework suitable to the fund managed;
(i) Guarantees compensation only for the first year of a new hire;
(j) Sets the fixed component high enough to allow paying no variable compensation;
(k) Limits payments on early termination so as to not reward failure;
(l) Performance awards should be risk adjusted to reflect all forms of current and future risks;
(m) At least 50 percent of the variable component should be in the form of equity;
(n) At least 40 percent and up to 60 percent of the variable component should be deferred and vest over a period appropriate to the life cycle and redemption policy of the fund being managed, but in most cases three to five years with pro rata vesting;
(o) Variable components shall only be payable if "sustainable" in light of the fund manager's financial position;
(p) Pension policy must be in line with the fund manager's long term interests and must be held back on early departure;
(q) Staff must undertake not to engage in personal hedging strategies; and
(r) Variable remuneration must not evade the requirements of Annex II.

Larger or more complex fund managers are expected to establish a remuneration committee chaired by and whose membership shall consist of non-executive persons (such as non-executive directors). In light of the above, *it appears that the FSB Implementation Principles will have application for alternative investment fund managers* and that the principle of proportionality will not be applied so as to exclude alternative fund managers from remuneration regulation and supervision.

Similarly in December 2010, the European Commission conducted a consultation on whether or not the next UCITS Directive (referred to as UCITS V) should adopt remuneration provisions consistent with the AIFM Directive described above.[20] The premise of the consultation was that UCITS managers should have remuneration policies and procedures based upon the FSB's Implementation Principles, but not because UCITS contributed to the 2008 financial crisis. Instead, UCITS Managers are to become subject to the Implementation Principles because UCITS can engage in complex and risky investment strategies, to avoid encouraging risk taking within UCITS (instead of within Alternative Funds), and because UCITS managers can be expected to be a part of larger financial services firms that might otherwise be subject to similar remuneration principles. The consultation period closed on the UCITS consultation January 31, 2011, and we await further action from the Commission. However, given the adoption of the AFIM Directive, and the stated objective of a level playing field between UCITS and Alternative Funds, it is reasonable to expect that UCITS V, when adopted, will have provisions responsive to the FSB's Implementation Principles that will be similar to those applicable to AIFM funds.

Dodd Frank: A Different Approach to Proportionality

On March 30, 2011, the SEC, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board); the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), Treasury the National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (FHFA) published a proposed rule (the Proposed Rule)[21] that would implement Section 956 of the Dodd Frank Act.

Under Section 956, the Agencies must adopt joint regulations to (i) prohibit "covered financial institutions" from entering into incentive-based compensation arrangements that encourage inappropriate risks (either because of excessive compensation or because they could lead to material financial loss to the institution) and (ii) require disclosure of incentive-based compensation arrangements.[22]

The Proposed Rule would apply to any "covered financial institution"[23] that has "total consolidated assets"[24] of $1 billion

or more and that offers an "incentive-based compensation"[25] arrangement to a "covered person"[26] (essentially, directors, officers, employees and principal shareholders). Certain requirements would apply only to "larger covered financial institutions," which in general are covered financial institutions with $50 billion or more in total consolidated assets.

In publishing the proposed rules, the Agencies noted that they considered, among other things, the FSB's Implementation Principles. Indeed, the proposed SEC rules closely track the Implementation Principles already summarized above, especially with respect to covered financial institutions with $50 billion or more in total consolidated assets.

Section 956 of the Dodd Frank Act defines "covered financial institutions" to include financial institutions, including investment advisers (whether registered or not) that have $1 billion or more in total consolidated assets (as opposed to assets under management). There is no capital adequacy requirement for registered investment advisers, *per se*. Indeed, the SEC noted in the Proposing Release that it does not collect information from investment advisers with regard to their consolidated assets.[27] Therefore, any investment adviser with consolidated assets of $1 billion or more presumably is "caught" by the joint rule proposals by another capitalization requirement (perhaps because it is a bank or a broker-dealer). Inasmuch as investment advisers have no requirement to maintain consolidated assets at any particular level, the Proposed Rules may not affect as many investment advisers as may be effected by the AIFM Directive and/or UCITS V. That being said, the Proposed Rules are part of the global regulatory trend, and are worthy of note. They are briefly summarized below.

Prohibition Regarding Excessive Compensation. As required under Section 956 of the Dodd Frank Act, the Proposed Rule would include standards for determining whether an incentive-based compensation arrangement provides "excessive compensation." Compensation for a covered person would be considered excessive when amounts paid are unreasonable or disproportionate to, among other items, the amount, nature, quality, and scope of services performed by the covered person. In making such a determination, an Agency would consider, among other matters: the combined value of all cash and non-cash benefits provided to the covered person; the financial condition of the covered financial institution; comparable compensation practices at comparable institutions; for post-employment benefits, the projected total cost and benefit to the covered financial institution; and any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution.

The Proposed Rule would implement the statutory prohibition on incentive compensation that encourages material financial loss. This prohibition would apply to three categories of covered persons: senior management; individual risk-takers; and members of risk-taking groups.

To avoid inappropriate risks, the covered financial institution would have to comply with three key risk management principles related to the design and governance of incentive-based compensation: (i) balanced design,[28] (ii) independent risk management controls[29] and (iii) strong governance.[30]

The Proposed Rule would also require the annual report to the appropriate Agency that would provide enough detail for the Agency to monitor the remuneration program.[31]

Policies and Procedures. The Proposed Rule would impose requirements regarding detailed policies and procedures and recordkeeping that the board (or committee) of each covered financial institution would have to adopt to ensure implementation, monitoring and independent oversight of incentive-based compensation arrangements, as well as adequate information supplied to the board of directors of the covered financial institution.

The policies and procedures would have to provide that each covered financial institution maintain sufficient documentation of the institution's processes for establishing, implementing, modifying, and monitoring incentive-based compensation arrangements sufficient to allow the applicable Agency to determine the institution's compliance with the Proposed Rule. Given that the determinations to be made regarding incentive-based

compensation are fact-specific, the proposing release notes that effective documentation of the covered financial institution's policies, procedures and actions related to incentive-based compensation is essential both to help promote the risk-based discipline that Section 956 of the Dodd Frank Act seeks to foster in covered financial institutions, and to facilitate meaningful oversight and examination. In this context, the Agencies would expect the documentation maintained by a covered financial institution under the Proposed Rule to include, but not be limited to:

- A copy of the covered financial institution's incentive-based compensation arrangement(s) or plan(s);
- The names and titles of individuals covered by such arrangement(s) or plan(s);
- A record of the incentive-based compensation awards made under the arrangement(s) or plan(s); and
- Records reflecting the persons or units involved in the approval and ongoing monitoring of the arrangement(s) or plan(s).

In addition, the proposing release notes that the use of certain hedging strategies by covered persons who receive deferred incentives in the form of equity-based awards could significantly diminish the effectiveness of the deferrals and undermine the underlying purpose of the policies and procedures. The Proposed Rule notes that the Agencies are therefore considering whether a covered financial institution's policies and procedures should be required to specifically include limits on personal hedging strategies.

In addition to the prohibitions and procedural requirements described above, the Proposed Rule would impose two additional requirements on incentive-based compensation arrangements at larger covered financial institutions: (i) a mandatory 50 percent deferral of incentive-based compensation for executive officers and (ii) board oversight of incentive-based compensation for certain risk-taking employees who are not executive officers.

The Proposed Rule would prohibit a covered financial institution from evading the restrictions of the rule by doing any act or thing indirectly, or through or by any other person that would be unlawful for the covered institution to do directly under the Proposed Rule. This anti-evasion provision is designed to prevent covered financial institutions from, for example, making substantial numbers of its covered employees independent contractors for the purpose of evading this subpart (although the Proposed Rule stresses that *bona fide* independent contractor relationships of covered financial institutions are not intended to be disrupted).

To date, the FSB's Implementation Principles have been applied by regulators only to specific cases. In the United States, the Agencies propose to apply the Implementation Principles and Dodd Frank Section 956 proportionally—not at all to investment advisers with less than $1 billion (in consolidated assets), to some degree to investment advisers that are large ($1 billion in consolidated assets) and fully to very large investment advisers ($50 billion in consolidated assets). The US version of proportionality accordingly has mitigated the potential impact of remuneration regulation and oversight by the SEC. The FSA has produced a similar outcome by designating most investment managers as Tier 4 firms. But in specific cases, the FSB Implementation Principles have taken hold: the case in point is the AIFM Directive. The EC is plainly contemplating a similar outcome for UCITS fund managers. Therefore, at the moment, the FSB's remuneration principles likely will be applied only to investment advisers if they also become "fund managers" for certain funds sold or managed in Europe. Presumably, this may cause investment managers to hesitate before entering these markets. And, perhaps the regulators in the United States and European Union will now observe whether or not their rulemaking inspired by the Implementation Principles will have the intended effect of reducing undue risk taking, as intended.

Notes

1. The SEC recently overhauled its registration form for investment advisers, Form ADV, effective October 12, 2010. *Amendments to Form ADV*, Investment Advisers Act Rel. No. 3060 (July 28, 2010). However, in that

connection, the SEC adopted no regulation of portfolio manager, trader or risk-related employee remuneration under the Advisers Act. The new SEC registration form for investment advisers does discuss compensation of investment adviser personnel that are *involved in sales* of advisory services, but not those that are involved in investment advisory or risk taking activities, *per se*. *See* Form ADV Part 2, Item 5 (requiring disclosure of sales incentives). Item 6 of Form ADV is devoted to the specific conflict of interest problem of "side by side" management attributed to a firm managing some accounts with performance fees and a firm managing some accounts without performance fees. *See* Form ADV Part 2, Item 6. Except in the instance of an investment advisory firm with one employee, Form ADV would not address investment professional or portfolio manager remuneration *per se*, and even in the limited instance of side by side management, Form ADV only requires disclosure. Neither Form ADV nor any rule adopted under the Advisers Act currently imposes regulation on remuneration practices by registered investment advisers. The SEC also mandates disclosure of compensation practices for portfolio managers of investment companies registered under the Investment Company Act of 1940, as amended. *See, e.g*., Form N1-A, Items 10 and 20 (with a focus on disclosure of compensation paid by clients other than the registered investment company and potential conflicts of interest). No forms of remuneration are proscribed, however for employees of firms that manage registered investment companies.

2. As used in this article, the term "investment adviser" includes investment advisers that act with investment discretion on behalf of their clients and hold a power of attorney to trade in their client's account. The term takes its definition from Section 202(a)(11) of the Advisers Act which defines "investment adviser" as follows:

> "Investment adviser" means any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities; but does not include: A. a bank, or any bank holding company as defined in the Bank Holding Company Act of 1956, which is not an investment company, except that the term "investment adviser" includes any bank or bank holding company to the extent that such bank or bank holding company serves or acts as an investment adviser to a registered investment company, but if, in the case of a bank, such services or actions are performed through a separately identifiable department or division, the department or division, and not the bank itself, shall be deemed to be the investment adviser; B. any lawyer, accountant, engineer, or teacher whose performance of such services is solely incidental to the practice of his profession; C. any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor; D. the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation; E. any person whose advice, analyses, or reports relate to no securities other than securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States, or securities issued or guaranteed by corporations in which the United States has a direct or indirect interest which shall have been designated by the Secretary of the Treasury, pursuant to section 3(a)(12) of the Securities Exchange Act of 1934, as exempted securities for the purposes of that Act; F. any nationally recognized statistical rating organization, as that term is defined in section 3(a)(62) of the Securities Exchange Act of 1934, unless such organization engages in issuing recommendations as to purchasing, selling, or holding securities or in managing assets, consisting in whole or in part of securities, on behalf of others; or G. such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order.

3. The Dodd Frank Act is formally known as The Dodd Frank Wall Street Reform and Consumer Protection Act of 2010. Section 956 of the Dodd Frank Act requires the seven US administrative agencies (including the SEC) to issue joint regulations that prohibit "covered financial institutions" from entering into incentive-based compensation arrangements that encourage inappropriate risks, either because they provide certain covered persons of the covered financial institutions with excessive compensation, or because they could lead to material financial loss to the covered financial institutional. Section 956 rulemaking is discussed in more detail below.

4. The G-20 was formed in 1999 in the wake of the 1997 Asian Financial Crisis, to bring together 19 of the world's largest national economies and the European Union (comprising the G-20) and emerging economies to stabilize the global financial market. Since its inception, the G-20 has held annual Finance Ministers and Central Bank Governors' Meetings and discussed measures to promote the financial stability of the world and to achieve a sustainable economic growth and development.

5. For a detailed discussion of the role of the G-20 in setting regulatory policy with regard to remuneration, *see* Guido A. Ferrarini and Maria Cristina Ungureanu,"Lost in Implementation: The Rise and Value of the FSB Principles for Sound Compensation Practices at Financial Institutions," International Centre for Financial Regulation Financial Times Research Prize Competition, 2010. (Noting that international cooperation is essential for effective implementation and that the FSB's precepts break new ground by aligning compensation with "prudent risk taking," rather than with returns to investors in the financial institution).

6. The G-20 established a Financial Stability Board in 2009 with the objective of implementing financial services reform. The FSB is designed to implement international supervisory and regulatory practices across the G-20. The FSB undertook three thematic reviews in 2010: (i) compensation (which is completed), (ii) risk disclosures by significant financial institutions, and (iii) mortgage origination.

7. Financial Stability Board, Principles for Sound Compensation Practices, April 2009. *http://www.financialstabilityboard.org/publications/r_0904b.pdf.*

8. The Financial Stability Board's September 2009 remuneration principles are available at: *http://www.financial stabilityboard.org/publications/r_090925c.pdf*.

9. In addition, in the event of governmental intervention (such as a bail out), compensation arrangements would have to be subject to restructuring, and direct regulatory review and approval.

10. Providing the "date" for EU directives is a bit of a challenge: adoption by Parliament sets off a process of enrollment in the Official Journal, which typically lags Parliamentary approval. In this case, the CRD III was published in the Journal in December 2010. As a practical matter, Parliamentary adoption set in motion timelines for a January implementation.

11. The CRD III remuneration rules are broadly consistent and the current United Kingdom Financial Services Authority (FSA) Remuneration Code (which sets out strict rules and guidelines for the remuneration policies of the largest (approximately) 27 banks, building societies and investment/brokerage firms operating in the UK.)

12. The Code has been drafted to implement recent amendments to the EU Capital Requirements Directive (CRD III) and also to reflect the Guidelines issued by the Committee of European Banking Supervisors (CEBS) on remuneration policies and practices under CRD III which were released on December 10, 2010.

13. UCITS refers to Undertakings for Collective Investment in Transferable Securities, which in turn takes its name from the UCITS Directive of the European Union first adopted in 1985. *See*, 13.07.2009—Adoption of the Directive 2009/65/EC (Recast of the Directive 85/611/EEC).

14. In the FSA's parlance "investment adviser" is a person acting without investment discretion, whereas under the Advisers Act the term includes both discretionary and non-discretionary advisers. We use the term "investment manager" to avoid using the term "investment adviser" when discussing the FSA's rulebook.

15. *Limited License firms* are, broadly, firms other than banks that are not authorized to deal on their own account or underwrite or place financial instruments on a firm commitment basis. *Limited Activity firms* are, broadly, firms other than banks which have a base capital requirement of €730,000 and either (a) deal on their own accounts only to execute client orders or to gain access to a clearing system when acting as agent or (b) do not hold client money or securities, do not provide investment services other than dealing on their own accounts, have no external customers for their investment services, and whose transactions are guaranteed by a clearing institution. *Exempt CAD firms* are, broadly, firms that are only authorized to provide non-discretionary investment advice and/or receive and transmit orders from investors and do not hold client money; these firms are outside the scope of the Remuneration.

16. The Code by its terms may apply to persons outside of the firm—as in the case of a parent company—where those persons have a significant influence over the FSA authorized firm, regardless of the jurisdiction of the parent.

17. The FSA's proposals with respect to reporting were published in December 2010.

18. As of this writing, the final version of the AIFM Directive was released on May 27, 2011, but not published in the Official Journal. As such, it is not yet fully adopted, pending publication. Upon publication of the official text the European Council stated that "The directive is intended to fulfill commitments made by the EU at the G-20, in the wake of the global financial crisis, as well as the European Council's pledge to regulate all players in the market that might pose a risk to financial stability."

19. *See* AIFM Directive, preamble, clause 24.

20. The EC's consultation paper can be found at: *http://ec.europa.eu/internal_market/consultations/docs/2010/ucits/consultation_paper_en.pdf*.

21. Notice of proposed rulemaking "Incentive Based Compensation Arrangements" *http://www.fdic.gov/news/board/2011rule2.pdf*.

22. Section 956 also requires the Agencies to ensure that their proposed regulations: (i) are comparable to the safety and soundness standards applicable to insured depository institutions under Section 39 of the Federal Deposit Insurance Act (the FDIA) and (ii) take into consideration the compensation standards described in FDIA Section 39(c).

23. A *covered financial institution* means, in the case of the SEC, (i) a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934, as amended (the Exchange Act); and (ii) an investment adviser, as such term is defined in Section 202(a)(11) of Advisers Act, *regardless of whether the adviser is registered under the Advisers Act*, in each case with total consolidated assets of $1 billion or more. The definition tracks the definition set forth in Section 956 of the Act, except that the Proposed Rule would expand the definition, pursuant to delegated authority under the Act, to include (i) the uninsured branches, agencies and certain other US operations of foreign banking organizations, and (ii) the Federal Home Loan Banks.

24. *Total consolidated assets* means (i) for a broker or dealer registered with the SEC, total consolidated assets reported

in the firm's most recent year-end audited Consolidated Statement of Financial Condition filed pursuant to Rule 17a-5 under the Exchange Act, and (ii) for an investment adviser, total assets shown on the balance sheet for the adviser's most recent fiscal year end. Importantly, the definition for an investment adviser is *not* based on assets under management, thereby excluding a large number of advisers that otherwise could have been swept into the Proposed Rule's scope.

25. *Incentive-based compensation* is defined broadly to mean any variable compensation that serves as an incentive for performance, regardless of whether compensation takes the form of cash, equity awards or other property. *Compensation* is also defined broadly to mean all direct and indirect payments, fees or benefits, both cash and non-cash, awarded to, granted to, or earned by or for the benefit of, any covered person in exchange for services rendered to the covered financial institution.

26. *Covered person* means, with respect to a covered financial institution, any of its employees, and each of the following:

- An *executive officer* of the covered financial institution, defined as any person who holds the title or performs the function (regardless of title, salary or compensation) of one or more of the following: president, chief executive officer, executive chairman, chief operating officer, chief financial officer, chief investment officer, chief lending officer, chief legal officer, chief risk officer, or head of a major business line.
- A *director* of the covered financial institution, defined as a member of the board of directors of the covered financial institution or of a board or committee performing a similar function to a board of directors.
- A *principal shareholder* of the covered financial institution, defined as an individual that directly or indirectly, or acting through or in concert with one or more persons, owns, controls, or has the power to vote 10 percent or more of any class of voting securities of a covered financial institution. Shares owned or controlled by a member of an individual's immediate family are considered to be held by the individual.

27. Proposing Release, fn.40.

28. Incentive-based compensation arrangements at a covered financial institution should balance risk and financial rewards. The Proposed Rule identifies four primary methods to make compensation better balanced between financial rewards and risk (while noting that other methods for achieving balance are likely to be developed in the coming years): risk adjustment of awards, deferral of payments, longer performance periods and reduced sensitivity to short term performance.

29. A covered financial institution should (i) adopt strong controls governing its processes for designing, implementing and monitoring incentive-based compensation arrangements, and (ii) ensure that independent risk-management personnel have an appropriate role in the institution's processes for designing, monitoring and assessing incentive-based compensation arrangements. Additionally, compensation arrangements for risk-management personnel should not be tied to the business unit results.

30. The board of directors of a covered financial institution should actively oversee incentive-based compensation arrangements, by reviewing and approving the overall goals and purposes of the covered financial institution's incentive-based compensation system and ensuring its consistency with the institution's overall risk tolerance.

31. At a minimum, the annual report would contain: a clear narrative description of the components of the covered financial institution's incentive-based compensation and specifying the types of covered persons to which they apply; a description of the covered financial institution's incentive-based compensation policies and procedures; for larger covered financial institutions, a description of any incentive compensation policies and procedures for the institution's executive officers, and persons with the ability to expose the institution to substantial loss; and the specific reasons the covered financial institution believes the structure of its incentive-based compensation plan is in compliance with the rules.

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