# ONCE UPON A TIME, I HAD A BONUS!

IN THE WAKE OF STRINGENT REGULATION DETAILING THE MANNER IN WHICH FINANCIAL REWARDS ARE TO BE DISPENSED BY INVESTMENT FIRMS, ONE CANNOT HELP WONDERING WHETHER HEFTY BONUS PACKAGES ARE NOWADAYS A THING OF THE PAST...

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It all started on the warm summer days of June 2007. A seemingly innocuous credit crunch hit the US markets. Investors had lost faith in the value of sub-prime mortgages. What initially seemed to be a passing summer storm, prolonged itself throughout all of summer, and resulted in the collapse of Lehman Brothers. Truth be told, the US Government had proposed a bailout plan, but the proposal was shot down by Congress. It was argued that taxpayers' money should not be spent to bail out Wall Street investment bankers, since these were believed to have been one of the principle causes of the financial crisis.

It was at that point that the salaries and bonuses received by the industry's risk takers started being scrutinised. Indeed, the underlying principle has always been the higher the risk, the higher the reward, for investors and traders alike. All traders felt safe in the knowledge that whatever happened, there would be a soft landing, with the regulator stepping in to save failing firms and thus shielding the market from a potential financial meltdown. But this did not happen in 2007. Institutions were allowed to fail. And global financial systems collapsed with them.

In the aftermath of the crisis, a lot of fingers were pointed (rightly or wrongly) in different directions. In Europe, the main 'culprits' of the financial crisis are to be brought into line by the AIFMD. By indirectly regulating hedge funds – which were seen to have played a part in prolong-

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ing the financial crisis because of the speculative nature of their investments – and their managers – which were effectively the entities spurring hedge funds to take greater risks – it is thought that the Directive will lead to greater economic stability and certainty in Europe. It is hoped that this will boost investor confidence, thus stimulating economic growth to pre-crisis levels.

So, besides introducing a harmonised regulatory framework for alternative investment funds, which were previously unregulated or subject to soft touch regulation, the ultimate aim of the Directive is to control and possibly reduce the level of risks taken up by such hedge funds. It also recognises that, invariably, it is the manager that decides to go for one risky investment, and not for another, long-term, safer investment.

This was the reasoning behind the introduction of remuneration polices through the AIFMD framework. Its ultimate goal is to set out clear and transparent polices, applicable to alternative investment fund managers, with the object of limiting, in so far as is possible, risk taking which contributes to the weakening of the financial system as a whole.

Not surprisingly, the fulcrum of remuneration policies is the promotion of sound and effective risk management. Risk taking should not be encouraged, since this could dramatically increase the risk of loss for investors, which, on a global scale, could in turn have severe ripple effects on financial markets. For this reason, guaranteed bonuses are nowadays granted only by way of exception and may only be granted to new staff for the first year of service. In addition, fixed and variable remuneration – which covers any payment or benefit made on the basis of performance, therefore including bonuses – must be proportionately balanced so that the fixed portion represents a sufficiently high portion of the total remuneration. Where variable remuneration is payable, at least 40% of it must be deferred over a period of time, typically three to five years, depending on the life span of the fund. Payment of the variable portion may only be made if the financial position of the investment manager permits it, judging by the performance of the fund itself. And, in addition to all this, the AIFMD also provides the possibility of the variable remuneration paid being clawed back.

It is not surprising, therefore, that the introduction of remuneration rules was a bone of contention within the hedge fund management world. The industry's initial uproar over the obligation to introduce remuneration policies has largely subsided. The remuneration principles today are a reflection of the compromise reached between the industry and regulators.

The compromise is that remuneration principles must be applied proportionately by regulators, taking into account, among other things, the particular investment manager's size, and the complexity of its organisations and activities.

It is no wonder that remuneration issues remain a key area of focus for all investment managers wishing to set up shop in Europe. The big benefit of Malta is the approach adopted by the Malta Financial Services Authority (MFSA) in relation to the practical application of the remuneration principles. Whereas the appointed manager of an alternative investment fund must apply the remuneration principles in accordance with the principle of proportionality, any sub-investment manager appointed by the alternative investment fund manager and to which portfolio management or risk management functions have been delegated, would not be subject to the remuneration principles applicable to the Maltese alternative investment fund manager.

This does not mean that the remuneration principles are avoided. These are still applicable to the Maltese alternative investment fund manager. In practice, this means that there would be no look-through by the MFSA to the remuneration policies and practices adopted by the sub-investment manager. Clearly, the choice of and the appointment of the delegate must be in line with the delegation principles set out in the AIFMD. However, any entity which is authorised to undertake investment management services and which is subject to supervision would be a good candidate for the post. Effectively, the delegate would only be subject to its own rules regarding remuneration policies and practices, and would not be subject to the AIFMD provisions regarding deferrals and claw back.

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From an individual's perspective, it is also worth noting that financial services professionals who relocate to Malta, and who are employed by the local investment managers, could benefit from a low fixed rate of income tax under the local highly qualified persons rules.

Remuneration issues will invariably remain a hot topic in the months to come. Now that the laws and rules are in place, investment managers must start operating within the AIFMD framework, in a way which makes sense in the context of their operations. Further clarifications and guidance may be expected from regulatory bodies as the remuneration principles are applied in practice. It will definitely have an impact on investment managers' compliance costs, with smaller investment managers possibly being pushed out of the market, unless cost-effective and value for money choices are made. At least in so far as the tale on bonuses is concerned, there might still be scope for a happy ending! ■