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The Committee of European Banking Supervisors
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By email to: CP42@c-ebs.org

10 November 2010

Dear Sirs

CEBS CP42: Consultation Paper on Guidelines on Remuneration Policies and Practices

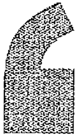
The British Private Equity and Venture Capital Association (the "**BVCA**") represents the overwhelming majority of UK-based private equity and venture capital firms. This letter sets outs the response of the BVCA to CEBS CP42. Our thanks to Mr Ivo Jarofke of the CEBS Secretariat for taking the time to meet with representatives of the BVCA on Thursday 21 October. We consider that meeting to have been constructive and positive. We are also grateful that CEBS has permitted us a short extension to its deadline for responses.

In the UK, undertakings in several private equity and venture capital groups ("**private equity firms**") are subject to MiFID and CAD and will be subject to the remuneration provisions of CRD3 with effect from 1 January 2011. Those firms are discretionary investment managers (within Article 20(2) CAD). Whilst some of the issues affecting those firms are also relevant to other types of asset manager, some aspects of their incentive arrangements are unique. In the Appendix, we set out illustrative diagrams of private equity fund structures (shared with Mr Jarofke at our meeting), including a written explanation and description of "carried interest" and "co-investment" which are particular features of our industry. We urge CEBS to consider them in detail before finalising guidelines applicable to firms which use such arrangements. We would be delighted to attend another meeting with CEBS further to explain them.

We understand that there is divergence between Member States as to whether or not MiFID (and hence the CRD) should be applied to private equity firms. In some EEA jurisdictions, all private equity firms are treated as being outside the scope of, or exempt from, MiFID. It is particularly important that CEBS should take a considered approach to the application of CRD3 to asset managers, including private equity asset managers, because of the potential to exacerbate an unlevel playing field within the Community.

The vast majority of BVCA members will be within the scope of the AIFM Directive with effect from H1 2013 (based on current expectations). As CEBS is aware, the draft AIFM Directive makes provision for remuneration regulation (in Article 13 and Annex II) which is in many respects (on its face) similar to the provisions of CRD3. However, CEBS will be alive to the subtle but important differences in those texts and the different context in which that legislation is to be implemented.

Whilst some private equity businesses currently subject to MiFID and CAD will in time become subject only to AIFMD, others may remain subject only to MiFID and CAD and a few may be subject to both.



1. Key points

Proportionality

We welcome the draft guidelines. In particular, we welcome the recognition by CEBS that the remuneration provisions of CRD3 must be applied proportionately and differently amongst different types of institution.

In practice, we believe that where a private equity firm employs certain typical incentive structures (a combination of salary and discretionary bonus funded out of secure investment management fees, together with participation in carried interest and/or co-investment schemes which provide potentially the most significant element of incentive and align the interests of senior individuals with those of investors over the long term), it would be proportionate for the governing body to conclude that the principles on deferral, share-based payment and performance adjustment can be neutralised in relation to that firm. The overarching objective of effective risk management will have been met.

Carried interest and co-investment arrangements are investment arrangements which feature inherent long-term deferral and risk adjustment characteristics, as well as distribution based only on realised (not accounting) profits. There is therefore an obvious and strong policy argument that carried interest and co-invest schemes satisfy policy objectives for deferral, share-based remuneration and performance adjustment. We elaborate on these arrangements in the Appendix and in the commentary in section 2 below.

We welcome CEBS' recognition (in light of Recital 4 of CRD3) that proportionality can lead to the complete neutralisation of some provisions. However, we also agree with CEBS that aspects of the CRD3 remuneration provisions, notably the governance provisions and the basic principle of risk alignment, are relevant to investment managers, including private equity firms.

At the public hearing on 29 October 2010, CEBS indicated that it was open to suggestions as to which other of the provisions should be capable of neutralisation. In section 2 below, we elaborate on the differences between private equity firm and other types of institution and, in that context, suggest additional provisions which should be capable of neutralisation.

Which staff?

We welcome CEBS' acknowledgement (in paragraph 16) that staff who have no material impact on a firm's risk profile should not be subject to the specific remuneration principles.

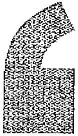
We also welcome the recognition (in paragraph 17) that (whilst partnership structures must not be used as a vehicle or method for circumvention of the rules) some of the remuneration requirements may not be applicable to partners in partnerships. We suggest that the same analysis could be applied to founders or owner-managers in legal structures other than partnerships (such as limited companies), to the extent that their distributions represent a return on investment or distribution of residual profits after other operating costs have been met, provided that the firm is adequately capitalised. It would be helpful if CEBS could state this expressly in the final guidelines.

Applicability of the draft guidelines to the AIFM Directive

At its public hearing, CEBS indicated that it hoped to receive a response to consultation from the Committee of European Securities Regulators, in particular on the application of the guidelines to investment firms.

We hope that CESR will provide a detailed and substantive response. However, whatever the extent of CESR's response, we believe it is crucial that it should be made clear on the face of the final CEBS guidelines that they have been developed by experts in the regulation of credit institutions and with a view to the pay practices of banks and investment banks, and that the public consultation has been conducted largely on that basis.

The AIFM Directive provisions on remuneration, whilst based substantially on the text of CRD3, are a separate piece of legislation, with subtle but important differences, particularly as regards the detailed regulation of remuneration structures. The AIFM Directive is also different from CAD in that its remuneration provisions are principally targeted at investor protection (what CEBS referred to at its public hearing as "conduct of business"), as opposed to prudential regulation. We believe that the



principles of good regulation will require CESR (ESMA as it will become) to undertake, before 2013, a more specifically targeted (but similarly in-depth) consultation into the application of the AIFM Directive remuneration principles to the particular financial sector which is the subject of that legislation, before publishing its own guidelines. Whilst close cooperation with the EBA in the development of ESMA's guidelines is likely to be required by the AIFM Directive, and is strongly desirable, there is a danger that some of those to whom the CEBS guidelines are addressed might place undue reliance on them as a simple template for ESMA's guidelines in the context of the AIFM Directive. We would therefore welcome an express statement in the final CEBS guidelines that the principal focus of CEBS' work has been on the banking and investment banking sector, and that the final guidelines reflect that emphasis.

Carried interest

Paragraph 13 of CP42 rightly makes clear that institutions should not remunerate staff through vehicles or methods which aim at artificially evading the requirements of CRD3. Amongst the examples given is that of a "carried interest model". Whilst we agree that artificial arrangements should not be created improperly to circumvent the CRD3 provisions (however they might be labelled), we are concerned that the reference to "carried interest" in this paragraph of the guidelines could be misinterpreted as criticism by CEBS of carried interest (as the term is understood by our industry and as it is described in the Appendix). We explain in this response that carried interest has been developed over many years at the insistence of investors as an effective means of risk management and how, from an economic perspective, carried interest and co-investment structures have desirable characteristics which meet the overarching policy objectives of CRD3. We therefore urge CEBS either to delete the reference in paragraph 13 to "carried interest models" or to adopt some carefully considered alternative phrasing to ensure that there is no suggestion that true carried interest models in the private equity sector are being maligned.

Retention periods

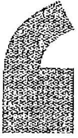
Although not a specific concern of private equity, we share the concerns of institutions in other parts of the financial sector about the interaction between deferral and share-based payment principles, including the application of retention periods (paragraphs 125-127). We urge CEBS to reconsider why it is appropriate or proportionate to require the application of a retention period to the share-based part of the deferred element of remuneration. Firms which cannot justify neutralisation of the relevant principle ought to have the flexibility to meet the objective of long-term alignment of interest by applying a longer deferral period but no retention period.

Impact on small firms, especially of public disclosure requirements

We also welcome CEBS recognition that all of the remuneration principles are subject to the overarching principle of proportionality (albeit that they may not all be neutralised). Whilst CEBS confirmed our understanding of the draft guidelines in this respect at its public hearing, we would welcome a single positive and express statement to that effect in the final guidelines.

This is vital because the vast majority of private equity and venture capital firms are very small when compared to other securities market participants, including deposit-takers, investment banks and many securities dealers. The smallest have only two principals and a few junior executives.

Small size is especially important in relation to public disclosure requirements. We agree with paragraph 145 of CP42 which states that the proportionality principle will apply to the type and amount of information disclosed. To that end, we suggest (and would welcome express recognition from CEBS that) it would be disproportionate to require any public disclosure of substantive remuneration arrangements by investment management firms, and that disclosure by such firms should be limited to a summary of their governance and controls around remuneration, with a focus on conflicts of interest management. To the extent that any quantitative data is required to be published (no matter how anonymised) it will otherwise be very easy to work out the remuneration packages of particular individuals. This would be a perverse outcome, given that CEBS contemplates that aggregate quantitative information should be published at the level of directors only by the most significant institutions. Private equity firms (unlike credit institutions) pose no systemic risks.



2. Differentiation between types of financial institution

The objective of CRD3 pay regulation is _effective risk management_ but the regulatory risks in an asset management context are simply different from those which arise in the banking and investment banking sectors.

The policy behind the CRD3 changes – to challenge remuneration structures which jeopardise effective risk management by "supporting" behaviour which puts the firm and even the wider market at risk – has limited resonance in the private equity and venture capital context. The draftsman of the CRD3 remuneration provisions had in mind credit institutions and investment banks which take principal positions. Those firms pose prudential risk and systemic risk. Their incentive structures, which have been highly publicised and are deeply contentious, include features such as significant annual discretionary bonuses determined by reference to accounting profit or profit which does not otherwise reflect all residual risks to the institution's balance sheet.

The solutions to some of the problems faced by such institutions rightly include:

- share-based payment, which such institutions can accommodate because their equity is typically admitted to trading on public markets;
- the contractual deferral of variable remuneration into future years, which such institutions can accommodate because shareholders are used to the idea that they should retain profits in their business; and
- an ongoing, embedded and dynamic risk alignment process which reflects the features of discretionary bonus "award" and "payout".

By contrast, private equity and venture capital managers do not present prudential or systemic risks. The key regulatory objective in this context should be investor protection i.e. to mitigate risks to the fund and to investors. The UK Financial Services Authority has recognised (and Lord Turner has stated publicly) that:

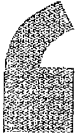
- the key remuneration risk relevant to asset management firms is the potential for conflicts of interest, as opposed to prudential or systemic risks; and
- incentive structures which align a fund manager's interests with those of its funds and investors should be left alone.

CAD is concerned with the prudential regulation of the institution, as opposed to investor protection. In the prudential context of CAD, the key risk affecting the success or failure of a private equity firm is the (mis)alignment of the firm's interests with the interests of the funds it manages on behalf of investors. This is because the only significant risk to the future viability of the licensed *firm* is that it disappoints investors, is unable to raise a future fund and cannot therefore secure further stable investment management fee income.

CRD3 recognises conflicts of interest as one important element of risk alignment, and it is relevant to private equity firms. In that respect, the regulation is proportionate and relevant. However, the real way potential misalignment is dealt with is by the use of the very carried interest and co-investment structures that are now becoming subject to scrutiny. Conflicts management is important, but it is those structures which really deal with the point. Potential conflicts of interest have also long been addressed by broadly-based yet detailed regulatory rules, including in MiFID and the MiFID implementing Directive which require firms proactively to identify and manage their conflicts. Those rules of course only elaborate on the existing contractual and fiduciary arrangements which mitigate conflicts.

The regulatory risks in an investment management context are different to those faced by such institutions, so the regulatory response should be different. We welcome CEBS recognition that this is so. Further, because investment management firms are typically privately owned and have no purpose for substantial retained profit, the structural solutions cannot be the same. It is for this reason that "neutralisation" of certain principles is justified and necessary so far as they relate to investment managers, including private equity firms. In particular:

- Annex V, section 11, point (o) – the requirement that a substantial portion of variable remuneration should be payable in shares. This requirement is clearly inappropriate for



institutions, such as the overwhelming majority of private equity houses, who do not have instruments in the management group admitted to trading on public markets.

- Annex V, section 11, point (q) – requirement for deferral. Where the most important part of incentive is not composed of an annual discretionary bonus (as with a bank or investment bank), mandatory deferral would be disproportionate and would not reflect existing incentive arrangements which satisfy the policy intent.

In addition to those principles which CEBS has already recognised as being capable of complete neutralisation, we believe that the following requirements should also be capable of being disapplied.

- **Annex V, section 11, point (h) – the requirement that the assessment of performance is set in a multi-year framework in order to ensure that the assessment process is based on longer term performance.** This principle contemplates a dynamic "award" and "payout" process in the context of contractual bonuses which are not an important feature in private equity. Risk adjustment in a carried interest or co-investment structure is ex-ante and inbuilt. The reference elsewhere in the principle to "the underlying business cycle of the firm" is also difficult to apply in an asset management context. A private equity firm benefits from a stable and predictable investment management fee.

- **Annex V, section 11, point (l) - the requirement on a firm to set a ratio between fixed and variable components of total remuneration.** This requirement is not meaningful in a typical private equity context, where the overwhelmingly important element of long-term incentive is not remuneration payable by the firm but rather an individual's participation in a carried interest and/or co-investment arrangement.

- **Annex V, section 11, point (r) – the variable remuneration is paid or vests only if it is sustainable according to the financial situation of the firm as a whole, and justified according to the performance of the firm, the business unit and the individual concerned etc...including malus and clawback arrangements.** Neutralisation of this principle in respect of ex-post adjustment is a logical corollary of neutralisation of the requirement for deferral. This principle has no relevance where a firm has justified the neutralisation of the principles requiring deferral and share-based payment in relation to variable remuneration. In paragraph 114 of the draft guidelines, CEBS recognises that ex-post adjustment can only be done if part of remuneration has been deferred. In private equity, carried interest structures are tailored up front so as to reflect specific risks. In paragraph 137, CEBS adopts the position that, where the principle cannot be neutralised, an "implicit" adjustment is never sufficient as a form of ex-post risk adjustment. Carried interest, combined with clawback, is ideally structured to align investor and employee interests. There is no need for a discretionary ex-post risk adjustment for carried interest because payments directly reflect the investment outcomes for investors. The alternative investment sector differs from credit institutions and investment firms in this respect; in those institutions, equity-linked remuneration is based on the performance of the entire institution, while carried interest can be tailored to the performance of individual funds in which investors invest.

If you would like to discuss this response, please contact me in the first instance on 020 7295 3233 or margaret.chamberlain@traverssmith.com.

Yours faithfully

Margaret Chamberlain
Chair – BVCA Regulatory Committee

cc: Mr Carlo Comporti, Secretary General, Committee of European Securities Regulators

APPENDIX

Note: The diagrams in Figures 1 and 2 are illustrative only and not all firms operate in the same way.

Figure 1: example legal structure for a UK-headquartered PE firm

External institutional investors

Key execs

intermediate holding structure not shown

Carried interest vehicle (commonly a limited partnership)

limited partners

limited partner

General partner company

FSA authorised manager (commonly a limited liability partnership) Usually, the investment committee sits here.

general partner

Fund vehicle (commonly a limited partnership)

Junior staff

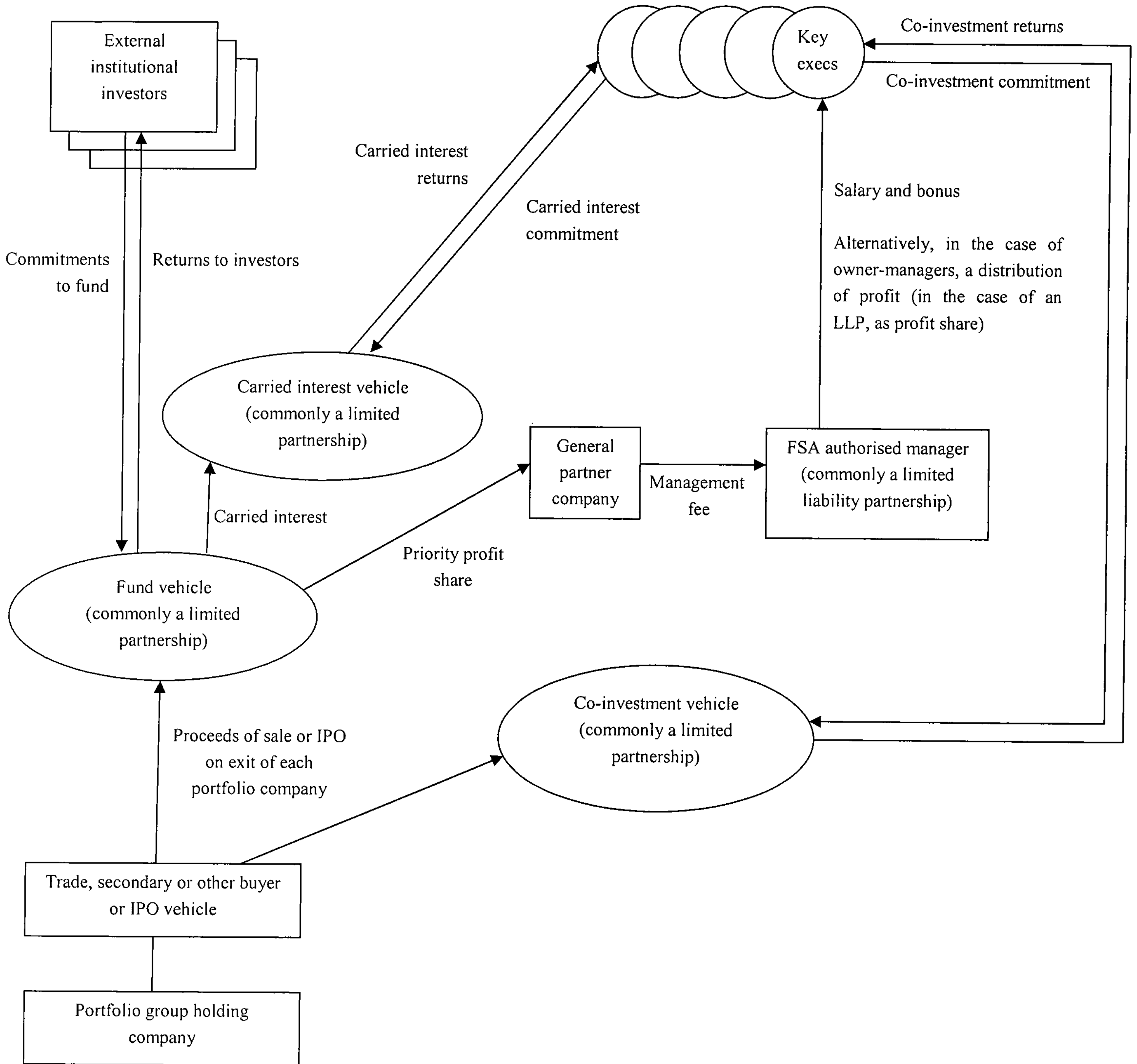
Co-investment vehicle (commonly a limited partnership)

limited partners

Portfolio group holding companies

debt finance

Figure 2: funds flow diagram



Explanation of Figures 1 and 2

- Investors make commitments to the fund. The amount committed is not drawn down immediately on closing but in tranches over the commitment period (typically four to seven years).
- Pursuant to the constitutional documents of the fund, negotiated at length with limited partners and their professional advisers, the general partner is entitled to priority profit share ("PPS"). In the early years of the fund (when there are no available profits) the PPS is funded by drawing down investor commitments.
- The general partner uses the PPS to pay the annual management fee on behalf of the partnership to the investment manager.
- The PPS/management fee are intended to cover the operating costs of the general partner and investment manager, including salaries and annual bonuses, as well as, in some cases, pension contributions and life and critical illness insurances. The PPS and management fee are committed and predictable over the entire life of the fund (typically ten years), although the amount typically adjusts on the expiry of the commitment period.
- There is no strong pattern as to the importance of bonus versus salary in this industry. It appears that salary represents about 70-75% of total cash (i.e. salary plus bonus) in the venture capital and the smaller mid-market private equity firms, and about 50-55% of total cash in the larger firms. It is clear, though, that the ratio of fixed to variable remuneration in this industry is considerably lower than in the banking and investment banking sector.
- Crucially, profits are achieved only on a successful realisation of the fund's investments, which might arise on the sale of the portfolio company group or on its initial public offering. Profits are therefore realised and real (as opposed to being based on accounting valuations). (Accounting profits may be reported to investors before realisation for the purposes of transparency but these are not relevant to funds flow.)
- In some cases, a portfolio company group may be refinanced during the period of ownership by the fund. In this case, there may be distributions to the fund earlier than exit, but again these profits are realised in the hands of the fund and there are no further risks for the fund. If a portfolio company were to get into financial difficulty (for example because of a subsequent deterioration in the economic cycle), the fund has no legal obligation to provide further capital (although it may do so if the investment manager considers this to be in the best interests of the fund).
- When the fund becomes profitable, the general partner is allocated PPS but its share of proceeds must first go to repay the draw-downs made in earlier years.
- Investors must receive back from the fund an amount equal to their drawn down commitments plus a preferred return (typically 8-10% p.a.). Only then does the carried interest vehicle start to participate in profits. After this "hurdle" has been reached, profits are split in accordance with a pre-determined formula in the fund constitutional documents, typically 80% to investors, 20% to the carried interest vehicle.
- Profits may accrue to the carried interest vehicle on a "whole fund" basis or a "deal-by-deal"

basis. The latter basis is declining in popularity and is not representative in the PE/VC industry. Under a "whole fund" model, the net proceeds of each realisation are applied first to the PPS, second to investors until the whole hurdle has been achieved, and only then to the carried interest vehicle. Under a "deal-by-deal" arrangement, a portion of the net proceeds of each realisation is allocated to the carried interest vehicle but will typically be held in escrow, subject to clawback arrangements, until the whole hurdle has been achieved. It should be noted, however, that some investors choose to enter deal-by-deal carried interest arrangements with lower profit share percentages (e.g. 10%), as they consider that this has a possibility of providing them with a better overall economic return.

Carried interest

Carried interest, and often co-investment, is required and negotiated by the fund investors and follows quite predictable norms dictated by fund investors. The key features of carried interest arrangements relevant to CRD3 remuneration requirements are as follows:

- The level/terms/design of carried interest receivable by the investment manager from its funds is negotiated between the firm and the investors in those funds. The investors are almost universally sophisticated institutional investors, who are well advised, with very significant buying and negotiating power. Typically two or three "cornerstone" investors will negotiate the terms of their commitment and the carry/co-invest arrangements. In the vast majority of cases, all other investors will join the fund on the same terms.
- To ensure alignment with their interests, investors will almost always require key members of the investment team at the investment management firm to have a carried interest and will often also expect to see a co-investment obligation.
- Carried interest "self–adjusts": it operates on a **cash to cash** (realised profits only) basis (in other words it is only payable once the original investment, plus costs, plus a rate of return or "hurdle" is achieved). It does not pay out based on accounting valuations, which may subsequently fall.
- It will normally be several years before carry payments are received by investors associated with the PE or VC house. There is, therefore, inherent "deferral" in carry schemes.
- Leaver terms will apply, meaning that an individual's entire interest can be lost if they join a competitor or if they are dismissed for cause. If they are a good leaver, then their interest will normally be scaled down to reflect the portion of the fund life/investment period for which they actively contributed.
- Based on figures kindly provided for the purposes of this response by MM&K, strategic pay and reward consultants (for which thanks), we believe that "carried interest working" represents on average between 70% and 85% of the total incentive of participants (including salary, bonus and carried interest). The concept of "carried interest working" is one which is commonly used by HR professionals in this industry. It reflects the carried interest scheme participant's interest in the most recent fund raised by the firm and represents the amount the individual would receive in the form of distributions if the fund "doubles its money". In other words, in order for the carry participant to receive distributions of this magnitude the fund investors would need to fully recover (on a cash to cash basis) their original investment in the fund plus a 100% profit.

Co-investment

The typical features of co-investment arrangements relevant to CRD II remuneration requirements are as follows:

- Co-investment is normally required by investors (and often the firm) to ensure alignment with their interests and to ensure that the investment team has personal "skin in the game".
- Team members within the PE firm invest their own money alongside the fund and on the same economic terms as the investors.
- In other words, they put at risk the loss of their own money through their stake.

There is no common method by which co-investment is funded. It will depend on the particular circumstances of the prospective participants and the level of the initial commitment.

Common variations on legal structure

The diagrams in Figures 1 and 2 above describe a typical legal structure for a UK-headquartered PE firm. However, there are very many possible variations on this structure. Common variations include:

- An investment manager acting as manager to several funds established in different years. The typical life cycle of a PE fund is about ten years. Once a first fund is approaching the end of its investment period, an investment manager will typically seek to raise a new fund.
- Establishing the fund vehicles offshore the UK, commonly in the United States or Guernsey, Jersey or another tax neutral jurisdiction. The object is to ensure that returns to investors are taxed in their hands in their own jurisdiction and do not suffer a second round of taxation at the fund level.
- Establishing a series of parallel fund vehicles bound together by co-investment contracts, so that from an economic and operational perspective they operate as a single "fund". This would be done to accommodate the needs of particular groups of investors. In this way, parallel fund vehicles of a single "fund" might be established in the UK, France, Germany, Luxembourg or other jurisdictions.
- The investment manager can be an LLP or a limited liability company.
- Entering into an arrangement with a "permanent capital vehicle", such as an investment trust, which acts as one of the investors in the firm's funds and/or invests directly in portfolio company companies in parallel to the funds. The permanent capital vehicle may or may not be grouped with the investment manager.
- Establishing the investment manager offshore the UK.
- Where the investment manager is outside the UK (and sometimes even where it is not) operating a separate company in the UK to operate as investment adviser to the manager and to arrange transactions for it in the local market. In these cases, the UK adviser-arranger will be an exempt-CAD firm for FSA prudential purposes.

- There are very many variations on the structure for holding portfolio companies which are not shown. For example, it is typical for interests in portfolio companies to be held on behalf of the fund by a nominee company controlled by the investment manager. In the case of a VC fund, it is less common to use portfolio group holding companies and there may be only limited debt finance.
- A management group may well be owned by its principals through a more complicated intermediate holding structure. One such possible structure involves the general partner itself taking the form of a limited partnership.
- Junior and mid-ranking staff may be employed and remunerated by a group service company, with the staff made available to the investment manager on a secondment or similar basis.