17 March 2021

On behalf of the Public Affairs Executive (PAE) of the EUROPEAN PRIVATE EQUITY AND VENTURE CAPITAL INDUSTRY

Response to EBA Consultation on Guidelines on sound remuneration policies under the Investment Firms Directive (IFD)

Question 1: Are the subject matter, scope and definitions appropriate and sufficiently clear?

Definitions

We note that the definition of "remuneration" catches carried interest within the meaning of AIFMD Article 4(1)(d). We would like to remind the EBA that carried interest, a basic element in private equity (including venture capital) fund structures, is an agreed percentage, at the fund's onset, of the cash profits of the fund. It is therefore not a "remuneration" but an incentive model comparable to a very specific type of performance fee.

This mechanism is a direct result of the long term outlook and the closed-ended structure of private equity funds where fund investors require from key members of the investment team at the investment management firm to be part of the carried interest base remuneration structure. Such a specific reward based on long-term performance is regarded as the main long-term incentive to the fund management team and as a key mechanism for aligning the interest of the fund manager and investors over the ten-year length of the fund.

Irrespective of how it is defined in existing EU law, **the typical carried interest model most importantly always satisfies the inherent policy intent of remuneration regulation.** Carried interest is indeed only paid out to the manager and/or to its executives who participate in the carried interest arrangements only once the external investors have:

- received back all of their drawn down capital (including typically in most cases also amounts drawn to pay the management fee);
- plus an agreed preferred return (currently, typically 8% p.a. on the investors' drawn down capital).

Only then does the carried interest vehicle start to participate in a percentage of the profits. After this preferred return has been reached, profits are allocated in accordance with a pre-determined formula agreed with investors and set out in the fund constitutional documents. In other words, carried interest operates on a cash-to-cash (realised profits-only) basis. It does not pay out based on accounting valuations.

The investors are almost universally institutional (professional) investors, who are highly experienced and well advised. To ensure alignment with their interests, investors expect key members of the investment team at the private equity group to be part of the carried interest based arrangements.

In some jurisdictions and markets, team members are required to co-invest[1] alongside third party investors in order to receive carried interest. In other jurisdictions and markets, there may be a strong investor expectation at least that this should happen.

Timing

We agree with the process that the guidelines must be implemented in respect of performance periods beginning on or after 1 January 2022.

Personal hedging

168. Investment firms should maintain effective arrangements to ensure that the identified staff member complies with the requirements of this section. At least a declaration of self-commitment by the identified staff member that he or she will refrain from concluding personal hedging strategies or insurances for the purpose of undermining the risk alignment effects is necessary. Where applicable, investment firms' human resources or internal control functions should perform at least spot-check inspections of the compliance with this declaration with regard to the internal custodianship accounts. Such random checks should at least include the internal custodianship accounts of identified staff. Notification to the investment firm of any custodial accounts outside the investment firm should also be made mandatory.

We consider that the proposed requirement that in-scope staff should have to notify the firm of any custodial accounts outside the investment firm is disproportionate because it goes beyond the personal account dealing requirements under MiFID and would require firms to impose an intrusive requirement on staff. We think that this assessment is strengthened by the fact that, as paragraph 165 identifies, the two most conspicuous ways in which staff might seek to hedge against the IFD remuneration requirements are by taking out insurance policies or entering into derivative transactions – neither of which are typically held in custodial accounts. We therefore think that the final sentence of paragraph 168 should be removed from the final guidelines.

Members of the supervisory function

178. In order to properly address conflicts of interest and without prejudice to paragraphs 178 and 179, members of the supervisory function should be compensated only with fixed remuneration. Incentive-based mechanisms based on the performance of the investment firm should be excluded. The reimbursement of costs to members of the supervisory function and the payment of a fixed amount for working hour or day, even if the time to be reimbursed is not predefined, are considered as fixed remuneration.
179. Where the supervisory function in exceptional cases is awarded variable remuneration, the variable remuneration and risk alignment should be strictly tailored to the assigned oversight, monitoring and control tasks, reflecting the individual's authorities and responsibilities and the achievement of objectives linked to their functions.

We do not agree that members of the supervisory function should only receive any variable remuneration in exceptional cases. Whilst it is the case that, as paragraph 178 of the draft guidelines notes, it is very important that remuneration of members of the supervisory function should not create conflicts of interest, we think that "exceptional cases" sets the bar too high, for two reasons.

[1] As a reminder, any returns from such co-investments, where they represent a pro-rata return on investments made by a firm's staff members, are not considered to be remuneration for the purposes of AIFMD, as per ESMA's guidelines on sound remuneration policies under AIFMD (para. 16). For the avoidance of doubt, this kind of arrangement should not be subject to the IFD guidelines either.

Firstly, as paragraph 179 implicitly acknowledges when it countenances variable remuneration paid to members of the supervisory function "strictly tailored to the assigned oversight, monitoring and control tasks … and the achievement of objectives linked to their functions", variable remuneration does not necessarily create a conflict of interest. Indeed, having the flexibility to reward members of the supervisory function for their performance in contributing to the effectiveness of that function is an important tool for firms to reduce conflicts of interest.

Secondly, the concern in the draft guidelines appears to be that the payment of variable remuneration to members of the supervisory function creates a conflict because it could incentivise them to promote the success of the firm inappropriately. To the extent this conflict does exist (and as explained in the preceding paragraph, it is not clear to us that it does), two important considerations need to be kept in mind:

(a) any conflict can be managed, for example through the setting of maximum ratios between fixed and variable remuneration; and
(b) it is disproportionate for smaller firms, which do not necessarily have separate management and supervisory functions, to be subject to such an inflexible standard.

We therefore believe that Title III, section 11 of the draft guidelines should be amended to provide that members of the supervisory function should only be compensated with variable remuneration where and to the extent that any conflicts of interest can be appropriately managed, taking into account the nature, scale and complexity and the risks inherent in the business model and the activities of the firm.

Bonus pools

227. Investment firms should define one or more bonus pools for the period for which variable remuneration is awarded and calculate the overall investment firm-wide bonus pool as a sum of these bonus pools.

The draft guidelines require the setting of bonus pools, and contain prescriptive obligations in relation to these. Whilst we recognise that investment firms must not undermine their capital and liquidity requirements under IFD/IFR, some firms, such as MiFID 'adviser-arranger' entities within alternative asset management groups, have predictable revenue streams (for example, advisory fees charged on a 'cost-plus' basis). We believe that it would be inappropriate and disproportionate to require such firms to set bonus pools and comply with associated obligations.

Allowing greater flexibility would also make sense purposively for such firms, where the most substantial part of remuneration awards typically takes the form of carried interest awards rather than bonuses. This is because bonuses are paid from firm balance sheets and so it is appropriate that bonus pools should be defined and that the performance indicators used to calculate bonus pools should include long-term indicators and take into account the firm's realised financial results.

However, carried interest arrangements do not involve firm balance sheets (any amounts paid are ultimately derived from underlying investment funds) and, as explained above, they inherently allow for specific reward based on long-term performance.

Question 2: Is the section on gender neutral remuneration policies sufficiently clear?

No comments.

Question 3: Are the sections on the remuneration committee sufficiently clear?

No comments.

Question 4: Are the guidelines on the application of the requirements in a group context sufficiently clear?

No comments.

Question 5: Are the guidelines regarding the application of waivers within section 4 sufficiently clear?

Waivers thresholds

85. Investment firm's subsidiaries that are subject to a specific remuneration framework must comply with their sector-specific requirements, including the calculation of thresholds for the application of waivers on an individual basis, where applicable. E.g. an investment firm's subsidiary with assets of EUR 110 million in a Member State where a threshold of EUR 100 million applies, cannot avail itself of a waiver, even if on a consolidated level the Union parent undertaking in a Member States that applies a threshold of EUR 300 million can apply the waiver as its consolidated assets are below EUR 200 million and the other conditions under national law in line with Article 32(5) of Directive (EU) 2019/2034 are met.

Regarding the application of waivers, the general principle and the example provided under paragraph 85 are not sufficient clear and could be further clarified, in line with the principles of legal and cross-sectoral consistency underlined in the Executive Summary of the Consultation Paper.

The IFD (Article 32(4)) introduces a *de minimis* waiver from the pay-out process, notably for investment firms with assets below the EUR 100 million threshold. This derogation is modelled after the Article 94(3) CRD, which provides for two waivers, the first one applying to "*an institution that is not a large institution (…) and the value of the assets of which is on average <u>and on an individual basis</u>* (…) *equal to or less than EUR 5 billion over the four-year period immediately preceding the current financial year*".

However, the example provided in the draft Guidelines could be read as implying a cumulative test, whereby an investment firm could only avail itself of the waiver where its assets are below the threshold both on an individual and on a consolidated basis. The example is perceived as creating doubt regarding the ability of an investment firm to avail itself of the waiver on an individual basis.

Our understanding is that this paragraph was meant to address a very specific risk of circumvention in situations where an individual firm may attempt to rely on the higher threshold to avail itself of the waiver, and may actually go beyond the issue of sector-specific requirements interacting with IFD.

We do not dispute the usefulness of the example as such, but we consider that the Guidelines should rely on a principle-based approach, in order to guide market participants and competent authorities in the application of the legal and regulatory framework.

We would therefore invite EBA to amend paragraph 85 so as to address the above, and explicitly state that the following principles should apply when implementing Article 32(4):

- in principle, an investment firm can avail itself of the waiver where, on an individual basis, it does not exceed the EUR 100 million threshold, or the relevant applicable threshold where the latter has been increased or lowered as per Article 32(5) and (6);

- this approach is subject to the application of sector-specific requirements and to the process for determination of identified staff, including at a consolidated level;

- where the relevant applicable threshold is exceeded on an individual basis, it is not possible for the investment firm to avail itself of a waiver on the grounds that on a consolidated basis, the (higher) applicable threshold in another Member State is not exceeded.

Application of the waivers

244. Without prejudice to the application of waivers under Article 32(4) of Directive (EU) 2019/2034, investment firms should implement a deferral schedule that appropriately aligns the remuneration of staff with the investment firm's activities, business cycle and risk profile and the activities of the identified staff members, so that a sufficient part of the variable remuneration can be adjusted for risk outcomes over time through ex post risk adjustments.
281. Where malus can only be applied at the moment of vesting of the deferred payment, investment firms may choose, where possible, to apply clawback after paying out or vesting of the variable remuneration. The application of malus may not be possible where the derogation under Article 32(4) of Directive (EU) 2019/2034 applies as the requirement to defer variable remuneration is not applied; investment firms should ensure that clawback can be applied.

Article 32(4)(a) of IFD contains a clear exemption from the deferral requirement at Article 32(1)(l). This is recognised in paragraph 281 of the draft guidelines, which spells out what flows logically from the exemption, namely that a firm may not be able to apply malus where the firm falls within the exemption (as there will be no deferral period), and prescribes, reasonably, that in such circumstances firms should ensure that clawback can be applied.

We therefore assume that where paragraphs 243 and 244 of the draft guidelines use the expression "[w]ithout prejudice to the application of waivers under Article 32(4)", this is intended to be interpreted as meaning "[s]ubject to the application of waivers under Article 32(4)". The alternative would be to read it as indicating that, in paragraph 244 for example, firms with Article 32(4) waivers should nevertheless implement a deferral schedule – which would be inconsistent with Article 32(4)(a) of IFD and paragraph 281 of the draft guidelines.

We would therefore be grateful if the language could be amended in the final text to use the phrase "subject to", to minimise the risk of any confusion.

Question 6: Is section 9 on severance payments sufficiently clear?

No comments

Question 7: Are the provisions on performance criteria sufficiently clear, which other performance indicators, e.g. regarding the performance of business units or portfolios, are used to determine the variable remuneration of identified staff?

No comments

Question 8: Is the section on the pay out in instruments sufficiently clear?

260. Where an investment firm does not issue any eligible instruments, but does not benefit from a waiver under Article 32(4) of Directive (EU) 2019/2034, it should apply for the use of an alternative arrangement, demonstrating that it does not issue such instruments.

261. Competent authorities, when deciding on applications to use alternative arrangements, should consider:
a. that for investment firms which are stock corporations (both listed and non-listed), shares or share-linked instruments are issued;
b. if it would be possible and proportionate for the investment firm to make use of share-linked instruments or equivalent non-cash instruments, subject to the legal structure of the investment firm;
c. if 'other instruments' under Article 32(j)(iii) of Directive (EU) 2019/2034 have been issued, which depends on whether an investment firm or an investment firm in the scope of consolidation has already issued such instruments and sufficient amounts of such instruments are available. Where investment firms are primarily wholesale funded, or rely to a large extent on additional Tier 1, Tier 2 or bail-in-able debt to meet their capital requirements, such instruments should be available for the purposes of variable remuneration, provided that these 'other instruments' comply with Commission Delegated Regulation mandated under the IFD;
d. If there are specific requirements under national labour law that prevent the use of an issued eligible instrument for the pay out of variable remuneration.

Although the wording of sub-paragraph (a) in paragraph 261 is not entirely clear, we think it could potentially be interpreted by competent authorities as only permitting them to approve pursuant to Article 32(1)(k) of IFD the use of alternative arrangements by firms which are not bodies corporate. We think that the final guidelines should clarify that this is not the case, and that it should be made clear that competent authorities should approve the use of alternative arrangements, including by bodies corporate, where these fulfil the same objectives as those instruments listed in Article 32(1)(j).

The wording at sub-paragraph (a) may be based on the paradigm of a listed bank (or similar), which is invariably in a position where it can issue further shares as part of remuneration arrangements. Other types of firm, for example unlisted MiFID firms within alternative asset management groups, are often in a very different position. Notwithstanding that they may be in corporate form, firstly, they may under their constitutional or similar documents be unable to issue further shares or share-linked instruments for remuneration purposes, and secondly, doing so could materially affect their ownership structures, as they are often wholly-owned subsidiaries within alternative asset management groups. For these reasons, they do not issue shares or equivalent ownership interests as part of remuneration awards.

Such firms typically provide remuneration awards which in a listed bank might make the form of listed shares through by procuring the issuance of units in carried in interest vehicles. Purposively, carried interest aligns the interests of staff in alternative investment managers and the investors in the funds they manage. As such, it resembles to some extent "non-cash instruments which reflect the instruments of the portfolios managed" (Article 32(1)(j)(iv). It would therefore be appropriate for carried interest awards to be the sort of "alternative arrangement" that competent authorities should be encouraged to approve.

Contact

For further information, please contact Christophe Verboomen (christophe.verboomen@investeurope.eu) at Invest Europe.

About the PAE

The Public Affairs Executive (PAE) consists of representatives from the venture capital, mid-market and large buyout parts of the private equity industry, as well as institutional investors and representatives of national private equity associations (NVCAs). The PAE represents the views of this industry in EU-level public affairs and aims to improve the understanding of its activities and its importance for the European economy.

About Invest Europe

Invest Europe is the association representing Europe's private equity, venture capital and infrastructure sectors, as well as their investors.

Our members take a long-term approach to investing in privately held companies, from start-ups to established firms. They inject not only capital but dynamism, innovation and expertise. This commitment helps deliver strong and sustainable growth, resulting in healthy returns for Europe's leading pension funds and insurers, to the benefit of the millions of European citizens who depend on them.

Invest Europe aims to make a constructive contribution to policy affecting private capital investment in Europe. We provide information to the public on our members' role in the economy. Our research provides the most authoritative source of data on trends and developments in our industry.

Invest Europe is the guardian of the industry's professional standards, demanding accountability, good governance and transparency from our members.

Invest Europe is a non-profit organisation with 25 employees in Brussels, Belgium.

For more information please visit www.investeurope.eu.