EUROPEAN
PRIVATE EQUITY &
VENTURE CAPITAL
ASSOCIATION

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

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Industry Response to the CEBS Consultation on the Guidelines on Remuneration Policies and Practices

The European private equity and venture capital industry welcomes the opportunity to respond to the consultation paper on Guidelines on Remuneration Policies and Practices published by the Committee of European Banking Supervisors (CEBS) on 8 October 2010.

Summary

The industry supports recent initiatives taken by the European institutions and other international bodies, such as the FSB, on sound remuneration policies in the financial sector, with the purpose to achieve a better alignment of interest between investors and asset managers; reduce systemic risk and to develop a more long term based remuneration policy. In the context of private equity and venture capital, these objectives are inherent to the business model.

The recent measures on remuneration policies in the financial sector, which were developed with the systemically-risky banking sector in mind, have now gained traction for all kind of financial institutions. But while private equity is a form of financial investment, it does not generate systemic risk for the economy at large and employs effective risk management techniques appropriate for its business model. Asset managers, banking institutions and investment firms have different functions and characteristics, and as a result represent different levels of systemic risk. It is important to recognise this in order not to impose regulation that goes against current, sound and investor friendly market practices.

Proportionality when applying remuneration measures is important and further a necessity for the private equity and venture capital industry which not only spans a large space of “assets under management” but further applies a robust model of interest alignments with its investors. Otherwise, the application of the provisions regarding fixed and variable remuneration components to carried interest for example, would be to the detriment of the investors’ interests.

In reality, no sector other than the private equity and venture capital sector guarantees such an alignment to this extent, thanks to the initial co-investment made by the fund managers. The remuneration structures of private equity firms align the interests of the firm and its executives with the interests of the Fund and its Investors. The managers in the private equity firms have to invest their own money either directly into the fund or through a feeder vehicle. This structure encourages focus on the transaction and its long term success as returns are only distributed to the managers as and when investments are both realised and realised so as to having generated a total return above an agreed rate across the fund's whole portfolio. Moreover, as with any investment, if the fund looses money managers will make the same proportionate loss on their investment. The capital gains received by fund managers is the sweat equity earned by the partners over time. They are granted by the investors at the beginning of the fund life and accumulated in value if and when the portfolio companies become successful. They are paid out in lump sums at the end of the fund life post off-set losses made in the portfolio and provided net profits remain. Carried interest rights and co-investment obligation together form an illiquid long term investment.

In addition, investors in private equity funds do not have the right to withdraw their capital (redemption rights) before the end of the fund’s life. Therefore their investment is illiquid during the term of the fund (although liquidity events are occasionally observed when investors sell their commitments to other investors). Given that the funds are not leveraged and that investors do not have redemption rights, it is unlikely that the activity of private equity funds poses any systemic

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risk. Furthermore, third party investors will negotiate what return they want on their money before they are willing to share profits in excess of that amount.

Private Equity compensation structures do not have the flaws and the associated risks that have been identified in arrangements in other parts of the financial sector, where bonuses often fail to take into account the long term impact of actions and where equity further vests with immediate effect. Carried interest is not, as is implied in these Guidelines, a potentially abusive means of evading a firm's responsibilities under remuneration regulations. It is market standard and has all the attributes already set out above.

Hence, if these guidelines are applied to such asset managers where the compensation of these managers is already aligned with investors' long term interest as described above it might translate in difficulties for these managers to implement proven mechanism that meet the objectives of the guidelines. The reference of carried interest in Section 1.1.1 (p.15) of the Guidelines, should be deleted (or made clear that it excludes such carried interest which is the result of the investment manager having invested in parallel with the fund investors) as carried interest in the context of these guidelines it taken out of context, and could result in outcomes going against, one of the objectives of achieving an alignment of interest in the long run.

Under the circumstance of the current financial crisis, capital gains incentives are necessary to encourage long term risk taking in fledgling companies that stimulate the economy. In particular, the private equity and venture capital industry should not be hampered in its ability to create new companies, industries and technologies.

Finally, we wanted to highlight the relation between CRD III and AIFM Directive. The latest draft of the AIFM Directive[1] (which will be formally adopted in the coming weeks) which takes into account the specificities mentioned above such as the alignment of investor's long term interest provided by appropriate carried interest structures. However, the AIFM Directive will not be directly applicable for, approximately, another two years, and nonetheless, during this period, some private equity firms will have to implement some CRD III requirements. Therefore we have some specific comments on points in the draft CEBS guidelines that could be particularly problematic as applied to private equity remuneration structures:

- *CEBS' proposal that the deferral period begins when "the upfront part of the variable remuneration is paid out" (para 116)* - the meaning of "paid out" is unclear in the context of share-like variable remuneration, and particularly unclear in the case of carried interest. The deferral period should begin on the date on which the individual concerned first receives a contingent right to receive variable remuneration, whether conditionally (e.g. subject to vesting and performance of a fund or funds) or unconditionally (e.g. a cash bonus).

- *CEBS' proposal that a retention period always be required in addition to the deferral period (paras. 125-127)* - In the carried interest context this would not work, as carried interest payments are made out of cash returns, often many years after the carried interest is first awarded, and is subject to clawback. If the deferral period is long enough, and the nature of the instruments in question are sufficiently aligned with investor interests, it should not be necessary to impose a retention period in addition to the deferral period.

- *CEBS' proposal that the 50% share-like variable remuneration requirement should apply to both deferred and non-deferred compensation (para. 130).* Carried interest is all deferred.

- *CEBS' position that an "implicit" adjustment is never sufficient as a form of ex post risk adjustment (para 137).* 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 European private equity and venture capital industry remains, as ever, committed to an ongoing dialogue with policy officials and interested stakeholders, and welcomes any comment on its response to the consultation.

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[1] http://register.consilium.europa.eu/pdf/en/10/st15/st15053-re01.en10.pdf

Notes to the Editor

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 EVCA

The European Private Equity and Venture Capital Association is the voice of European private equity and venture capital, representing more than 1,300 members. In addition to promoting the industry among key stakeholders, such as institutional investors, entrepreneurs and employee representatives, EVCA develops professional standards, research reports and holds professional training and networking events.

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