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

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AIFMD Variable Remuneration rules

The carried interest perspective

Note: *This paper aims to supplement the industry's official response to the European Commission consultation on the AIFMD review, in particular Question 60.*

The AIFMD remuneration policy (Annex II of the Directive) applies to "remuneration of any type paid by the AIFM, to any amount paid directly by the AIF itself, **including carried interest**".

In the context of the consultation launched by the European Commission on the AIFMD, we would like to reiterate the importance of carried interest as one of the basic tenets of the private equity industry. Such a structure, which aligns the incentives of managers of these closed-ended funds with those of investors that committed long-term capital into them, should be encouraged rather than discouraged. Would the carried interest model no longer be allowed under AIFMD, this could have wide ranging implications for all types of private equity structures, from venture to growth and infrastructure funds, whose role will be of crucial importance in supporting businesses in a post-Covid environment.

Is carried interest a "remuneration"?

Carried interest, a basic element in private equity fund structures, is an agreed percentage, at the fund's onset, of the cash profits of the fund. It is therefore not as such a "remuneration" but is rather 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. It allows for specific reward based on long-term performance. As such, it 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.

Carried interest is indeed only paid out to the manager and/or to its executives who participate in the carried interest arrangements once the external investors have:

- received back all of their drawn down capital (including in most cases also amounts drawn to pay the management fee);

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- 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 fact, in some jurisdictions and markets, it is a legal requirement that team members co-invest alongside third party investors in order to receive carried interest. This is mirrored by the strong investor expectation of identical or similar commitments across other jurisdictions and markets.

The importance of the "proportionality principle"

The very specific nature of carried interest is the main reason we support the current proportional approach (including "neutralisation" of certain remuneration principles) on grounds that – and to the extent that – some variable remuneration rules are effectively disproportionate to the nature, scale and complexity of a particular AIFM's business.

The enshrined proportionality in AIFMD rules allowed Member States that have experience of the private equity model to develop specific requirements for carried interest. It also allowed ESMA to clarify in paragraph 159 of its Remuneration Guidelines that there may be exemptions to the rules for a situation in which: a) an AIFM must first return all capital contributed by the investors of the AIF it manages and an amount of profits at a previously agreed hurdle rate (if any) to the investors of the AIF, before the identified staff of the AIFM may receive any variable compensation for the management of the relevant AIF; and b) the compensation received by the identified staff of the AIFM is subject to clawbacks until the liquidation of the relevant AIF.

Although not all carried interest models meet that description, carried interest models of similar types are currently recognised by NCAs as satisfying the policy objectives underlying the regime.

Any change in the interpretation of the proportionality principle, and therefore the vanishing of such safeguards, will **substantially undermine established incentive arrangements applied in the private equity industry**.

Should AIFMD rules no longer be applied in a proportionate manner (due to the desire to harmonise the AIFMD framework within MiFID/R and CRD/CRR), carried interest mechanisms may no longer benefit from the recognition, reflected in current national approaches in Member

States and in paragraph 159 of the ESMA Guidelines, that certain remuneration regimes, although not strictly meeting the criteria for deferral, payment in instruments and ex-post risk adjustment (principles (m), (n), (o) in AIFMD Annex II), are effectively compliant with the goals of the regime.

For example, it will normally be several years before carried interest-based payments are received by the manager and its executives / "identified staff", who are incentivized through these arrangements. There is, therefore, inherent "deferral" in carried interest-based arrangements but no deferral in the sense of paragraph (m).

Existing remuneration requirements, including ones on deferral, payment in units and risk adjustment, are designed for structures (i.e. investment bank annual cash bonuses) that differ radically from those that are the norm in private equity. Provisions in these legislative acts may be appropriate and necessary in many parts of the financial sector but pose a fundamental challenge to one of the core features of private equity, the carried interest model, where the current arrangements already achieve what is being intended. To apply those rules without the proportionality principle would in most cases be practically unworkable.

Switching off proportionality would ultimately serve to **reduce the alignment of interests between investors and fund managers and could lead to perverse outcomes, which would not serve investors' interests and may be regarded by investors as a retrograde step in protecting their exposure.**

A targeted caveat as an alternative to proportionality

We understand the potential desire to harmonise EU rules on variable remuneration may in itself be an objective that must be pursued by the European Commission for a broader purpose. But it would have dramatic effects, were the AIFMD to be reopened and proportionality to be removed as a principle, if such an harmonisation was not accompanied by ***specific and targeted caveats*** to reflect the idiosyncrasies of the specific industry it regulates.

In order to avoid the scenario outlined above, the only viable option will be to essentially transpose some targeted elements of "proportionality" into the Annex of the Directive. This will ensure that there is a specific treatment for specific remuneration arrangements (such as carried interest) provided they meet certain conditions and/or are deemed to have an equivalent effect to the existing remuneration policy, as follows:

...(s) in relation to a closed-ended AIF, principles (m) (payment in units or shares) and (n) (deferral) and the final sentence of principle (o) (malus and clawback) may be met by the AIFM establishing an arrangement under which relevant staff have a direct or indirect right to share in an agreed proportion of the profits of that AIF; provided that:
(i) such arrangements are established with a view to enhancing the alignment of interests between (i) the investors in the AIF and (ii) relevant staff and/or the AIFM over the life of the AIF; and
(ii) under such arrangements, relevant staff are not entitled to retain their agreed proportion of such profits unless, at the end of the life of the AIF (or in the case of, for example, listed AIF which do not

have an 'end of life', the end of the relevant scheme or arrangement), all of the capital contributed by the investors to the AIF has been returned to them plus an agreed level of return (if any) on that capital;...

De Minimis thresholds: an insufficient option

Mentioned as a potential solution in Question 60 of the AIFMD review consultation, **a de minimis threshold may be helpful** but does not represent a viable solution from a carried interest perspective. Indeed, should there be proposed a de minimis threshold (for example by reference to the total on- and off- balance sheet assets of the AIFM – as under the Investment Firms Directive), it is unlikely to be sufficient in any case as the carry model is used by firms of all sizes.

However, de minimis thresholds, which are already used in practice in some Member States under the "proportionality principle", could be introduced at EU level.

They should, as is the case in MiFID and CRD, take into consideration the size, internal organization as well as the nature, scope and complexity of the activities of the relevant AIFM. Conditions on the job markets should also be considered: those are competitive and global, and it may be difficult to attract the appropriate skills and competences, as they are volatile and can relocate easily. Too restrictive rules might have unintended consequences and in the end benefit non-EU jurisdictions.