bvca The voice of long-term investment

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Mr David Raikes
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8 October 2010

Dear Mr Raikes

FSA CP10/19: Revising the Remuneration Code – Fuller Response

This letter sets outs the response of the British Private Equity and Venture Capital Association (the "BVCA") to FSA CP10/19. The BVCA represents the overwhelming majority of UK-based private equity and venture capital firms.

Thank you for taking the time to meet with representatives of the BVCA on Friday 3 September. We consider that meeting to have been constructive and positive. It laid the foundations for this response.

We refer to our letter dated 26 August 2010 addressed to Mr Matthew Fann, lead supervisor for private equity firms, in which we made some initial comments. Those comments have been developed in this response, so that it stands alone. We would welcome a further meeting to discuss the issues raised by us in this fuller response.

We consider this consultation paper to be amongst the most important to which our Association has responded. We understand that CRD3 is not the FSA's own policy initiative. Nevertheless, the issues raised are of huge significance and of very grave concern to our membership. We suspect that the UK private equity and venture capital industry will be unique in Europe in having to deal with the issues prior to the implementation of the Alternative Investment Fund Managers Directive (the "AIFM Directive"). It is our understanding that very few private equity and venture capital firms in other parts of Europe are treated as falling within CRD3 due to differences in interpretation and structures in other Member States. It is therefore critical that the UK approach to this issue does not make life for UK firms unnecessarily more onerous than it is for their EU competitors.

We identify a few areas where we believe that the FSA approach is superequivalent to what is required by CRD3 or FSMA and as a result imposes unnecessary burdens on firms. We do not think any such provisions are appropriate and they should be removed. The FSA is already well ahead of other Member States in implementation and UK firms should not be further disadvantaged.

We note that the draft AIFM Directive is likely to make further provision on pay regulation. At the time of writing, the final form of the AIFM Directive remuneration provisions is unknown. Nevertheless, we place significant reliance on the repeated references in the latest compromise text (put forward by the Belgian Presidency of the Council) to the need to apply the AIFM Directive remuneration principles "in a way and to the extent [our emphasis] that is appropriate to [the] size, internal organisation and the nature, scope and complexity of [the AIF's] activities". Whilst ideally this would be made clearer in the AIFM Directive text, and whilst there are some differences in the detail of the draft AIFM Directive texts and the CRD3 provisions on remuneration, we believe that such text will give the FSA the same

opportunity to adopt a comply or explain approach, as did recital 4 to CRD3 (which recognised that it might not be appropriate to apply some CRD3 remuneration principles at all to investment managers). We therefore respond to CP10/19 on the basis that the Code or something similar will apply in time to a very large number of private equity and venture capital firms. We also hope that this response will also help to inform the UK authorities' continuing engagement with the EU institutions on the AIFM Directive.

Our response is comprised of the following parts:

We have prepared Part D in order to answer the questions you raised during our meeting about typical structures used in our industry, and Part E to address the relative importance of remuneration (i.e. salary and bonus) compared to the incentives provided by participation in co-investment and carried interest arrangements. Part D is a very important element of our response.

MM&K, strategic pay and reward consultants, provided the raw data on which Part E of our response is based.

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 sincerely

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Margaret Chamberlain
Chair – BVCA Regulatory Committee

cc: Thomas Huertas, FSA
Dan Waters, FSA
Giles Swan, FSA

Part A: Key Points

I. Effective risk management and proportionality in the context of private equity and venture capital

(a) We welcome the FSA's public statements that firms should be required to apply the Code proportionately. This requires an assessment of the risks in a particular business for which remuneration controls are an appropriate management tool. In practice, for private equity and venture capital firms, we believe that this should mean that where a firm employs certain typical incentive structures it would be disproportionate to apply the proposed rules on deferral, share-based payments and performance adjustment to that firm at all. The overarching objective of effective risk management will have been met, as we explain further below.

The typical structures we refer to are a combination of salary and discretionary bonus, usually funded out of 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.

Carried interest and co-investment arrangements are not remuneration. However, they are investment arrangements which feature inherent long-term deferral and risk adjustment characteristics, as well as distribution based only on realised cash profits, not unrealised accounting profits. There is therefore an obvious and strong policy argument that carried interest and co-invest schemes in any event satisfy policy requirements for deferral, share-based remuneration and performance adjustment.

Should the FSA (or CEBS) not accept our suggested approach, then it will be practically impossible to apply many of the detailed rules (designed for other sectors) to the standard PE/VC incentive structures, particularly carried interest and co-investment arrangements. If this were to force changes to existing arrangements there would be significant problems. Changing these arrangements is not the same as making changes to an employment contract since they are an important part of the structure agreed with investors. Changes would require renegotiation with investors. This would not necessarily be straightforward, would be costly and time consuming and would put the UK industry at a competitive disadvantage to firms elsewhere, as it would be the only part of the global industry seeking to renegotiate arrangements with investors. In this respect CRD3 differs from AIFMD in that it is focussed on the firm not the fund and does not on its face recognise carried interest.

(b) In support of the proposition in (a) above we note that the objective of CRD3 pay regulation is *effective risk management* and the regulatory risks in an asset management context are simply different from those faced by larger multi-function institutions for which the CRD3 remuneration provisions were designed.

We welcome the FSA's recognition that the remuneration provisions of CRD3 are addressed to, and have been designed for, larger multi-function institutions, including deposit takers and investment banks, and agree with the comments made by Lord Turner at the FSA's Asset Management Sector Conference to the effect 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.

Incentive structures in the private equity and venture capital sectors already align manager and client interests. They have been developed over many years at the insistence of sophisticated institutional investors with precisely that objective. Conflicts of interest which might arise have long been addressed through the general law and investor demands for contractual protections, as well as regulatory rules which require firms proactively to identify and manage their conflicts. The UK industry is used to the regulatory focus on these issues. In this context, draft Remuneration Principle 3 is relevant and important.

Please refer to Part B, Section 1 for more detail.

II. Scope: what is remuneration?

References to remuneration need clarification in a number of respects.

Sums distributed to participants in carried interest and co-investment schemes are not remuneration in any ordinary sense, and they are not treated as remuneration for legal or tax purposes. They are returns on investment.

Not every payment should attract the remuneration rules. The legitimate distribution of profits to business owners is not remuneration, it is a return on capital. Sums paid for the acquisition of businesses and companies are capital receipts, not remuneration.

We encourage the FSA to recognise the fundamental character of carried interest and co-investment schemes and other distributions of profit and to refer to them in its policy statement, rules and guidance in this way.

Please refer to Part B, paragraphs 2.1 to 2.7 for more detail.

III. Scope: application to groups

The application of the draft rules to groups is particularly problematic and the draft rules are unclear. We understand that the rules on groups are intended to be an anti-avoidance measure i.e. to prevent firms establishing offshore or unregulated entities to employ and pay their staff in a manner inconsistent with the principles. We further understand that the intention is to apply such anti-avoidance measures only to members of UK consolidation groups (or non-EEA sub-groups) on a consolidation (or sub-consolidation) basis. It will be vital to make clear on the face of the Code that the only staff of affiliates who are to be treated as Remuneration Code staff are those whose professional activities have a material impact on the risk profile of the consolidation group as a whole.

Please refer to Part B, paragraphs 2.8 to 2.15 for more detail.

IV. Scope: application to individuals

The draft Code also fails to take into account the fact that some executives perform functions on behalf of more than one undertaking. This is particularly common where the UK entity is part of a much larger international group with non-UK headquarters. In such cases individuals may well genuinely have roles within more than one group company, for corporate governance and/or other reasons. To the extent that they are Remuneration Code staff in relation to one firm, the only part of their remuneration subject to the Code should be so much as relates to their employment by the firm in scope (i.e. the CRD investment firm). In some cases it needs to be recognised that that may be nil. The Code should not set up incentives to distance overseas owners from UK governance.

The definition of Remuneration Code staff is too widely drawn and not every significant influence function or control function should be in scope. If they were in scope, smaller firms will have proportionately many more persons registered than large banks. Each firm will be best placed to make a fully reasoned assessment of which staff in its business carry on professional activities that materially affect the firm's risk profile and therefore constitute Remuneration Code staff.

Please refer to Part B, paragraphs 2.16 to 2.29 for more detail.

V. Clarity

It is vital that the final form of the Code is clear in its application to all affected firms. The draft Code, which draws heavily on CRD3 text, does not yet meet this requirement. We highlight in this response some key areas where this is the case. Firms must not be left in a position of legal uncertainty. It is contrary to basic principles of natural justice given the powers of the FSA to void contracts.

Please refer to Part B, Section 8 for more detail.

VI. Taxation

It must be an important principle that remuneration regulation does not give rise to tax liabilities that do not currently arise, or impact upon the ability of firms and individuals to pay their tax bills in the way they do now. The deferral provisions in the draft Code presently create: (a) tax timing problems for members of limited liability partnerships and others who must pay tax in the year in which profits arise even if distribution of those profits is deferred; as well as (b) tax timing differences for employers (who may obtain tax deductions only for amounts "paid" within nine months of the year end). We do not believe that there is any justification for imposing such financial burdens as a consequence of pay regulation.

Part B: Topics

1. Effective risk management and proportionality in the context of private equity/venture capital - assessing risk and determining the regulatory response

1.1 The overarching requirement of CRD3 and the revised Code is for in-scope firms to "establish, implement and maintain remuneration policies, procedures and practices that are consistent with and promote sound and effective risk management" (SYSC 19.2.1R). It is essential, in implementing CRD3, that the FSA recognises that the risks that need managing through pay structures vary according to the type of firm. We agree with the FSA's analysis, as explained in recent speeches, that the principal asset management risk that is relevant in this context is the conflict of interest risk. We believe that the typical private equity/venture capital industry structures, developed over many years in conjunction with investors, effectively deal with this risk by aligning investor and manager interests. The FSA (and IOSCO in its work on conflicts) have recognised this and it is important that this recognition is carried through to the implementation of the Code.

1.2 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 CRD3 remuneration provisions are drafted with a view to deposit-taking 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.

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

1.3.1 share-based payment, which such institutions can accommodate because their equity is typically admitted to trading on public markets; and

1.3.2 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.

1.4 To date, remuneration requirements under SYSC 19 have applied only to 27 of the UK's largest banks, building societies and investment banks. CRD3, on the other hand, now applies to investment managers, although without there having been any regulatory or other analysis as to why there should be any such extension. It is regulation without reason. We recognise that the FSA cannot change the law but it can, in accordance with principles of interpretation of European law, apply it with a purposive construction.

1.5 We agree with the FSA's statement in paragraph 2.29 of the consultation paper that the definition of risk will vary according to the type of firm. (We explain in the following paragraphs what we consider the key risks to be.) The regulatory response should therefore

also be different. Since private equity and venture capital investment management firms are typically privately owned, the structural solutions cannot be the same as for institutions which issue securities for which there is a market and which are therefore capable of being both priced and sold.

1.6 PE and VC 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. The draft remuneration provisions of the AIFM Directive – in more recent drafts – begin to recognise this by referring to risks to the AIFM and the AIF.

1.7 In the prudential context of CRD3, the key risk affecting the success or failure of a PE or VC firm for the purpose of SYSC 19.2.1R 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 FSA authorised firm is that it disappoints investors, is unable to raise a future fund and cannot therefore secure further stable investment management fee income. To the extent that this is best described as operational risk, we agree with the FSA's conclusion in paragraph 2.29 of the consultation paper. We acknowledge that a few PE firms do face other risks to their continued viability as a result of their particular business model, for example, where there is significant reliance on a single cornerstone investor, but these are not the norm. These risks are not however linked to their incentive models and are already addressed by the FSA's prudential rules.

1.8 We strongly disagree with the FSA's statement in paragraph 2.29 of the consultation paper that a key risk arising from asset management activities is legal risk, at least if the FSA were to take that view in relation to private equity and venture capital. We know of no reason why such a statement would be advanced in this context. Legal risks for PE and VC firms are materially less than for many other types of investment management firm. Investment and divestment decisions are typically made by committee (as opposed to independent traders running a book) with reference to the investment objectives and mandate of the fund. There are no complex custody, collateral or settlement arrangements.

1.9 PE and VC fund structures invariably include arrangements which have been developed over many years at the insistence of sophisticated institutional investors specifically with a view to effective alignment of interests. We describe these arrangements in Part B below. In particular, carried interest and co-investment arrangements feature inherent long-term deferral and risk adjustment characteristics, as well as distribution based only on realised (not accounting) profits.

1.10 Potential conflicts of interest have long been addressed in a private equity/venture capital context through the general law and investor demands for contractual protections, as well as regulatory rules which require firms proactively to identify and manage their conflicts. The most common and effective structures for dealing with the risk of potential misalignment of interests are carried interest and co-investment. Their critical and effective role should be recognised in any discussion on conflicts, risk management and reward structures.

1.11 We invite the FSA to agree with us that, provided a particular PE or VC house employs certain typical structures, it would be disproportionate to apply the detailed draft rules on deferral, share-based payments and performance adjustment to that firm at all. Such typical structures are a combination of: (a) salary and discretionary bonus, each typically funded out of predictable investment management fees or, in the case of discretionary bonuses, actual realised profits, together with (b) carried interest and/or co-investment schemes which effectively align the interests of managers with those of investors in the funds over the long term. Where a firm's incentive structure exhibits these features, the overarching objective of effective risk management will have been met. It would be proportionate for a firm employing these structures to justify its non-compliance with draft SYSC 19.3.45R to 19.3.50G inclusive and the other rules described in the FSA's Proportionality Table 3, and to adopt flexible approaches to the rules listed in Table 2, particularly since those detailed rules have been designed to suit markedly different institutions. We elaborate in Part D below on the features of carried interest and co-investment arrangements.

1.12 There are some variations from the typical structure, which arise for legitimate reasons. For example:

1.12.1 Not every PE and VC firm operates *both* a carried interest and co-investment arrangement. For example, it is an important and attractive feature of our industry that small teams of managers from time to time leave established PE and VC houses and establish new fund management businesses. Owing to the high costs of set-up and demands on cashflow borne by the principals, investors may not require them to establish and fund co-investment arrangements in respect of their first fund. We believe that it should be possible for some PE and VC firms to conclude that the fact of a carried interest arrangement alone is sufficient to justify non-compliance with the principles set out in Proportionality Table 3, again provided that: (a) they comply with the mandatory rules in Proportionality Table 1; and (b) they can satisfy themselves that they have robust arrangements for identifying, avoiding and managing conflicts of interest in accordance with SYSC 10, Capital Markets Bulletin Issue 3 and Remuneration Principle 3. The Code should not operate as a barrier to professionals setting up their own, smaller firms, since this would stifle competition, be contrary to investors' interest and would impact negatively on the availability of capital to the UK and European economy.

1.12.2 A particular firm's organisation may also mean that salary and bonus are not funded entirely out of investment management fees. For example, a firm which manages capital provided by an affiliated permanent capital vehicle (such as an investment trust) alongside capital committed to its funds may not earn management fees on the permanent capital. We do not consider that the fact that salary and bonus are not funded (or are not entirely funded) out of management fee income should prejudice the firm's ability to adopt a proportionate approach, provided that the objective of risk management is nevertheless met.

1.13 Therefore it is important that the FSA is not too prescriptive in defining the circumstances in which a particular firm's arrangements justify a proportionate approach. Any FSA guidance should be framed by reference to the objective of effective risk management and, in particular, the alignment of interests.

1.14 Applying the detailed requirements to carried interest and co-investment arrangements produces a range of significant difficulties described below. If the approach we suggest is not adopted there will be real problems for UK firms with the bizarre effect of undermining or destroying the very arrangements that investors want to see and obtain from their managers elsewhere in the world. We describe the particular problems in paragraphs 1.15 to 1.24 below.

Carried interest and co-investment arrangements meet the policy objective of, but not the detailed rules for deferral, share-based payment and performance adjustment

1.15 If the FSA (or CEBS) does not accept the case made in paragraphs 1.1 to 1.14 above, there is an obvious and strong policy argument that carried interest and co-invest schemes in any event satisfy policy requirements for deferral, share-based remuneration and performance adjustment. However, because they are tailored to the performance of funds (and therefore indirectly to that of the firm) there are significant issues in applying the rules as drafted to such arrangements, as we describe below. In order to deal with the practical problems we describe, it would be necessary substantially to overhaul the draft Code in several important respects to give a purposive rather than literal interpretation of the Directive. Alternatively (and preferably), we think that the appropriate means for addressing the concerns set out in this section is by allowing firms to justify non-compliance in line with the proportionality principle provided for in CRD3. We consider that this should be acceptable given that the arrangements deliver the policy objectives.

1.16 *Share-based payments:* Subject to the legal structure of the firm, SYSC 19.3.45R requires the payment of at least 50% of variable compensation in the form of shares or share-linked instruments. The draftsman appears to have had in mind shares, warrants, options or similar instruments issued by the employer. In many privately owned firms this will not be practicable. The rules do contemplate that unlisted employers may find it difficult to meet the requirement and they refer to "equivalent non-cash instruments". The consultation paper also refers to "other long dated financial instruments that adequately reflect credit quality". Carried interest or co-investment rights in a typical PE or VC structure do not obviously fit into this wording but achieve the same objective.

1.17 There are likely to be adverse taxation consequences of requiring unlisted firms to set up a share scheme. HM Revenue & Customs values investment management firms on multiples of their fees, which is likely to lead to an artificially inflated "market value" for shares issued. Where shares are issued below this "market value", the member will be taxed on the difference (and may face a tax bill that exceeds the value of the shares themselves).

1.18 There is also the important practical question of how staff could ever hope to realise their

holdings in highly illiquid instruments in a privately owned group.

1.19 Participation in carried interest and co-investment schemes is difficult to fit into the literal wording of the requirement for share-based remuneration, because the relevant interests are not issued by the firm itself and because carried interest and co-investment do not in any case constitute remuneration (variable or otherwise) (see section 2.3 below). Nevertheless, for the reasons given they do meet the relevant policy objectives.

1.20 *Multiple funds:* The detailed rules are also hard to apply sensibly to PE or VC firms which operate several parallel funds with different investment strategies. The best and most efficient way to align an executive's incentives with "their own" strategy and investor base is to allow or require them to invest in the relevant fund or to have co-investment or carried interest entitlements in or alongside it so that their return is driven primarily from the fund they are investing (which is also a key conflict management tool). Aligning the interests of the executive with the performance of the investment management *firm* overall, as appears to be contemplated by SYSC 19.3.45R, would not be so targeted.

1.21 *Deferral:* There are similar difficulties in applying the rules on deferral to carried interest and co-investment arrangements. The prohibition on "providing" variable remuneration components sooner than "three to five years" is inconsistent with a typical carried interest or co-investment scheme. Whilst such schemes might not be expected typically to make any distributions to participants in the first three to five years, there is no structural mechanism to prevent such returns from happening if the hurdle (see Part D below) has been met following strong performance and actual returns to investors. To accommodate the detailed rules would require substantial and costly revisions to fund documentation, for example to introduce escrow arrangements, as well as the agreement of the fund investors who would no doubt be concerned at the "misaligning" of their interests with the executives in question.

1.22 *Thresholds:* In seeking to comply with the quantitative thresholds for both share-based payment (50% of variable remuneration) and deferral (up to 60% of variable remuneration), it is likely to be very difficult for PE and VC firms to attach a value to awards other than cash payments (including carried interest and co-investment rights). The question arises, should the arrangements be taken into account in the remuneration year in which a right to participate is awarded (where relevant), the remuneration year when the investment is made, or the remuneration year when the participant obtains a distribution from the scheme? The logical answer would be to arrive at value at the time of investment in the scheme (since that most nearly corresponds to the "award" of remuneration). However, there are practical difficulties in arriving at any meaningful value, owing to the contingent nature of the return.

1.23 *Performance adjustment:* It is our view that typical carried interest and co-investment arrangements do reflect the policy objective behind the rules on performance adjustment (SYSC 19.3.48R). This is because they are based on realised profit returned to external investors (such that poor performance of investments results in no or lower returns from the scheme), and because they typically include vesting and "leaver" provisions which reduce the amounts due to investors associated with the PE or VC house but who leave the firm (the

mechanisms depending on whether the person is a "good" or "bad" leaver). However, those structural arrangements are not necessarily compliant with the detailed draft rules, because the mechanisms built into such schemes relate (entirely appropriately) to the future financial performance of the *fund* (as opposed to the future performance of the *firm*).

1.24 *Golden hellos:* "Guaranteed variable remuneration" is not a common feature of the PE and VC industry. Nevertheless, if deferral were required in respect of an individual's salary and bonus, then this might be likely to have the perverse effect of encouraging their use in our industry. If it became relevant, we would be concerned that the drafting of SYSC 19.3.38R is not clear. In particular, it is not clear how in practice to apply the requirement to limit guaranteed variable remuneration "to the first year of service".

2. Scope

Definition of "Remuneration"

2.1 The proposed Glossary definition of "remuneration" is "any form of remuneration, including salaries, discretionary pension benefits and benefits of any kind". SYSC 19.2.5R states that it includes "remuneration paid, provided or awarded by any person to the extent that it is paid, provided or awarded in connection with *employment* [given its expansive Glossary definition] by a firm".

2.2 We understand that "remuneration" is intended to catch only benefits provided to a natural person in respect of the provision of his or her services. For example, a distribution of profits by a firm to a member which is a body corporate should not be caught, but remuneration provided by that body corporate to an "employee" of the firm (as defined in the Glossary) would be caught if it were in respect of employment by the firm. For example, a payment made through a personal service company would clearly be caught. This should be made explicit in the Code.

2.3 We believe strongly that the right to participate in carried interest and co-investment arrangements is not properly regarded as "remuneration". Individuals use their own money to co-invest through or alongside the funds managed, which is typically required as an upfront investment for their entitlement to participate in carried interest. Distributions represent a return on their investment, or capital gain. This is consistent with the stance of HM Revenue & Customs. Please refer to Part D below which describes carried interest and co-investment arrangements in detail.

2.4 We acknowledge that the AIFM Directive may seek to impose restrictions not only on remuneration but also on investment returns, including by making specific reference to carried interest, and to treat such returns (for these narrow regulatory purposes) as if they were remuneration. Crucially, our central suggestion advanced in section 1 above does not rely on the fact that carried interest (and co-investment) rights are not "remuneration". Rather, our suggested approach to proportionality means that it is not necessary to grapple with the problems identified in paragraphs 1.15 to 1.24.

2.5 Similarly, we do not believe that the right of a principal of a PE or VC firm to acquire a capital interest in the manager on promotion to that rank should constitute "remuneration". This has the character of ownership, as opposed to remuneration. We would ask you to reflect this in the final policy statement.

2.6 When an FSA authorised firm (or its group) or their business is sold, it is common for the consideration payable to the former owners to be deferred (for example it might take the form of an "earn out"). This is common because it can be difficult to predict what will be the value of the business two or three years after completion. Where a principal or senior manager receives deferred consideration in these circumstances we do not consider that this should be treated as "remuneration" (even if he continues to work in the business after its sale) on the basis that it is paid by the purchaser in consideration for acquiring an ownership interest/goodwill (as opposed to being paid or awarded by the firm in connection with *employment*). It is relevant to PE and VC managers who might wish to expand by acquisition, as well as to their funds when they invest in financial services portfolio companies. This should also be covered in the policy statement. We acknowledge that there is a need to distinguish consideration from remuneration but consider that it will be relatively straightforward to establish whether there has been a bona fide transaction.

2.7 Please refer to paragraphs 2.26 to 2.30 below concerning staff who perform functions on behalf of multiple undertakings. In paragraph 2.29, we propose an amendment to the definition of "remuneration".

Application to groups

2.8 When we met, we discussed our grave concerns about a lack of clarity in the application of the draft Code to groups. Larger PE and VC houses may have relatively complicated group structures, including very many undertakings worldwide. Some of these will be authorised and regulated by the FSA, of which some but not all will be within the scope of the Code either on implementation of CRD3 or implementation of the AIFM Directive. Others will be regulated in other EEA Member States or elsewhere. Unregulated undertakings may constitute "financial institutions" or "ancillary service undertakings" within the scope of consolidation in BIPRU 8.5. Still others will be entirely unregulated.

2.9 In the following paragraphs we refer to the firm subject to the Code in its own right as the **"trigger firm"**.

2.10 When we met, you explained that you consider paragraph 22(ie) of Annex V to the BCD (draft SYSC 19.3.1R) to be an anti-avoidance provision, intended to prevent a trigger firm from employing and remunerating its staff through a service company or similar arrangement outside the scope of the rules. We consider it vital that this should be made clear on the face the Code and in the policy statement.

2.11 You confirmed the FSA's view that this anti-avoidance provision must be applied (only) at the level of any *UK consolidation group* or *non-EEA sub-group* on a consolidated (or sub-consolidated) basis in accordance with BIPRU 8.5.

2.12 We understand that this is the only relevant test for the application of the Code to groups. SYSC 19.1.2G(1)I states that the Remuneration Code "takes into account activities of other *group* members". This is very unclear and apparently at odds with the conclusions in the previous paragraph. That guidance should be deleted.

2.13 We explained that, having identified the undertakings within the scope of the anti-avoidance rule, it is unclear how the Code must be applied to them in practice. Draft SYSC 19.3.2G cross-refers to SYSC 12.1.13R which requires a trigger firm to ensure that its group has adequate, sound and appropriate risk management processes and internal control mechanisms at the level of the *group*, including sound administrative and accounting procedures. It also has the effect of requiring the trigger firm to "ensure that the risk management processes and internal control mechanisms at the level of any UK *consolidation group* or *non-EEA sub-group* of which it is a member must comply with the obligations set out in the Remuneration Code on a consolidation (or sub-consolidation) basis". What does the reference to "risk management processes and internal control mechanisms" mean? We assume it is intended to mean a subset of the Remuneration Principles, i.e. the high level Principles 1 to 6, 10 and 11. This needs to be clarified.

2.14 If the FSA has in mind that Principles 8 and 12 could apply to undertakings within the scope of consolidation then it is essential that this is operated only as an anti-avoidance provision and does not result in a member of senior management of an affiliate which is not subject to the Code directly (for example an affiliate which is an exempt-CAD firm) being treated as Remuneration Code staff. Rather, individuals who are employed only by affiliates of the trigger firm (and not by the trigger firm itself) should be treated as Remuneration Code staff only if their professional activities materially affect the risk profile of the trigger firm or the consolidation group as a whole and then only to the extent that their overall remuneration is attributable to that role. This is, in our view, the only sensible way to interpret a requirement to apply the Code "on a consolidation basis".

2.15 These questions are relevant to larger private equity groups which might contain several FSA authorised firms only one of which is a trigger firm. They are also relevant to PE and VC firms which are "captives" of banking groups, including those which are already subject to the existing Code.

The definition of "Remuneration Code staff"

2.16 The term "Remuneration Code staff" is defined as those *"whose professional activities have a material impact on the firm's risk profile"* (SYSC 19.3.4R). However, some of the FSA's proposed guidance on Remuneration Code staff appears to extend far beyond this and we have significant concerns that if applied as suggested it could result in smaller, non-systemically important firms having more Remuneration Code staff than larger institutions who present real risks to the financial infrastructure.

2.17 Some private equity and venture capital firms might conclude that in reality it is only investment committee members who are covered.

2.18 We note that draft SYSC 19.3.6G(3)(b) is super-equivalent to CRD3 in its inclusion within the category of "Remuneration Code staff" of holders of significant influence functions under the approved persons regime. We believe that this guidance should be deleted, relying instead on the reference in the definition to "senior managers", which is capable of more flexible and proportionate application.

2.19 This is of particular concern to the very many PE and VC managers structured as limited liability partnerships because each CF4 member holds a significant influence function. Please refer to section 5 below.

2.20 It is also a significant problem for some smaller firms, in which someone must hold controlled functions 10 (compliance oversight) and 11 (MLRO). These are both significant influence functions. For the reasons set out in paragraph 1.8 above, we do not believe that it is proportionate to the legal or compliance risks faced by *most* PE and VC firms automatically to treat the compliance officer and MLRO or other heads of support functions as Remuneration Code staff, whether on the basis that they are significant influence function holders or that they perform "control functions". It should be made clear that particular staff performing "control functions" cannot automatically be assumed to be Remuneration Code staff in every case. Each firm will be best placed to make a fully reasoned assessment of which staff in its business carry on professional activities that materially affect the firm's risk profile and therefore constitute Remuneration Code staff.

2.21 Some compliance officers are remunerated relatively modestly. They may also have responsibilities for other middle and back-office functions such as IT or financial control. In some cases they do not have the opportunity to participate in carried interest and co-investment arrangements. However, they may not be able to qualify for the de minimis concession in draft SYSC 19.3.6G(1) because their variable remuneration exceeds 33% of total remuneration. Provided that such variable remuneration is linked to the achievement of objectives linked to their functions (as will be required by Remuneration Principle 5 in any case), it is inappropriate to require deferral, share-based payment or performance adjustment. For such staff, deferral could cause real financial problems. If such staff are to be treated as Remuneration Code staff, we believe that there should be a further de minimis concession (to the same effect as SYSC 19.3.6G(1)) based on a simple total compensation threshold of, say £200,000.

2.22 It is not clear how "risk-takers" is to be interpreted in a PE or VC context. The guidance on risk-takers in SYSC 19.3.6G(3)(d) and (4) is drafted with a multi-function investment bank in mind. We start from the proposition that the only individuals who should be treated as Remuneration Code staff are: (a) members of senior management; and (b) members of a firm's investment committee, notwithstanding that their professional activities are principally relevant to the risk profile of the *fund* as opposed to the *firm* (see paragraph 1.6 above). We would welcome guidance on this point in the policy statement and the final form of the Code.

2.23 We refer to the proposed de minimis threshold in SYSC 19.3.6G:

2.23.1 We understand that SYSC 19.3.6G(1) is intended further to narrow the categories of staff who will be treated as Remuneration Code staff, and that it is not intended to set up an expectation that anyone receiving total remuneration in excess of £500,000 should be treated as Remuneration Code staff for that reason alone. We would welcome clarification of this in the final rules and the policy statement.

2.23.2 Please refer to our comments in paragraph 1.22 above about the difficulty in attributing value to rights to participate in carried interest and co-investment schemes. Those comments are relevant also to the application of the de minimis threshold.

Staff who are not Remuneration Code staff

2.24 We note also the FSA's expectation (set out in draft SYSC 19.2.3G) that firms will apply certain of the principles (including those requiring deferral and risk-adjustment) *"on a firm-wide basis"*. In our view, these principles are not relevant to, and should not apply at all in respect of, non-Remuneration Code staff (i.e. those staff whose professional activities do not have a material impact on the firm's risk profile).

2.25 At the very least, SYSC 19.3.3R should be amended to make clear that the "proportionality principle" applies when the revised Code is applied on a firm-wide basis (i.e. as well as when it is applied to Remuneration Code staff only).

Staff with other responsibilities

2.26 It is extremely common for executives who work for a PE or VC trigger firm to perform functions also on behalf of other undertakings. A particular undertaking might be: (a) a member of a UK consolidation group with the trigger firm; (b) a member of a group other than a UK consolidation group with the trigger firm; (c) a company pursuing common commercial objectives with the trigger firm, for example under contractual arrangements between them; or (d) an undertaking entirely unconnected with the trigger firm.

2.27 We understand that the intention of the draft Code is to regulate so much of the remuneration of the individual as is provided (by any person) in respect of functions performed by that individual in connection with employment by the trigger firm.

2.28 For example, if an individual is a director (CF1) of a trigger firm or a director of a parent undertaking (CF00) of a trigger firm, but is also a director of an non-UK affiliate company which, for example advises a non-UK fund, then we understand it to be the intention that the remuneration of the individual should be subject to the Code only in so far as it is attributable to services he provides to the UK trigger firm. This will be subject to the application to groups suggested in paragraphs 2.8 to 2.15 above.

2.29 It is crucially important that there should be explicit guidance in the final Code and in the policy statement to this effect. In order to make this clearer, we suggest that draft SYSC 19.2.5R(1) should also be amended to read:

"In this chapter references to remuneration include remuneration paid, provided or awarded by any person to the extent that it is paid, provided or awarded in connection with employment by ~~a~~ the firm".

2.30 It will be for each affected firm to apportion remuneration of an individual between functions performed for the trigger firm and functions performed on behalf of other undertakings. Firms may already carry out such apportionments for tax purposes. We believe that there will be some situations in which it is appropriate to conclude that an individual's remuneration in respect of employment by the trigger firm is negligible or nil.

3. Extra-territorial scope: overseas impact and competitiveness

3.1 The problems outlined in section 2 above will be particularly acute where the individual performs functions (perhaps his principal functions) on behalf of an undertaking outside the scope of the Code established and operating in a jurisdiction other than the UK (and doubly acute where that jurisdiction is non-EEA). Any approach different to that which we have suggested has the potential to be extremely controversial.

3.2 The overall effect of FSA rules should be to facilitate arrangements under which the senior staff of, say, US and Asian headquartered groups can play an active governance role in relation to their UK subsidiaries without those individuals' remuneration being subjected to European pay regulation. The Code should not set up perverse incentives to distance such owners from UK governance.

3.3 Apart from the application to groups (see paragraphs 2.8 to 2.15 above), we understand that the extended Code will apply only to UK authorised firms in respect of their UK regulated activities and activities passported into other EEA Member States. We note that paragraph 3.24 of the consultation paper implies a broader scope, and it is essential that this is clarified.

3.4 To the extent that: (a) a trigger firm has branches in other EEA Member States; or (b) the effect of the grouping anti-avoidance rules is that some non-UK staff are treated as Remuneration Code staff, firms subject to the UK's draft Code will be placed at a significant competitive disadvantage compared to other PE and VC groups which do not have any UK consolidation group or non-EEA sub-group. This is because:

3.4.1 the FSA proposes to take an approach to UK domestic implementation of CRD3 which is more stringent than that which we expect will be applied elsewhere;

3.4.2 many other Member States do not treat any PE or VC managers as subject to MiFID or CRD; and

3.4.3 the Code will include voiding provisions inspired by the Financial Services Act 2010, which is a piece of UK domestic policy.

4. Owner-managed firms

4.1 There is a further important respect in which rules designed for banks are inappropriate for many of our members. The vast majority of PE and VC firms are owner-managed businesses and the owner-managers are often the founders of the firm. Pay regulation is inappropriate for owner-managers. They cannot be compared to persons whose services are available for hire, they are the very reason the business exists and will have made significant tangible and intangible investments in it. If the firm is structured as a partnership, they are likely to be partners (see section 5 below). In a corporate structure, they are likely to be shareholders and directors (perhaps referred to colloquially as "partners"). In either case, they will be caught by the proposed definition of "Remuneration Code staff" (see paragraphs 2.16 to 2.23 above). In many structures, they may not receive any remuneration which is "awarded" by the firm (in an economic sense), but may instead be entitled in their capacity as equityholders to whatever remains after external capital providers have been compensated and expenses met. Nevertheless, it appears that their returns are intended by the FSA to come within the definition of "remuneration" (see paragraphs 2.1 to 2.7 above). Such a result would be entirely counterintuitive and contrary to the commercial reality.

4.2 It serves no meaningful regulatory objective to regulate returns due to owner-managers in this way. Certainly, the proposals are not tailored adequately to their particular position. For example, if a firm were to breach the requirement on deferral triggering an obligation to claw back under draft SYSC 19 Annex 1, paragraph 5R, is it intended that the amount clawed back must be retained as (taxable) profit in the firm which can never be distributed to owners irrespective of the firm's capital position?

5. Application to limited liability partnerships

5.1 There are several respects in which it will be difficult to apply the draft Code to firms structured as limited liability partnerships (**"LLPs"**), limited partnerships (**"LPs"**) or partnerships. The issues for each of them are broadly similar but we refer below only to LLPs for simplicity.

5.2 *Remuneration Code staff:* We refer to paragraph 2.18 above, in which we note that the draft definition of "Remuneration Code staff" catches anyone performing a significant influence function. We note that controlled function 4 (partner) (which extends to a member of an LLP) is a significant influence function. This means that every member of an LLP will be Remuneration Code staff regardless of whether they would otherwise fall to be treated as senior managers or "risk takers" within the firm.

5.3 Members of an LLP might be senior managers, but could also be more junior partners or owners with little or no involvement in the day-to-day operation of the business. It is common for LLPs to delegate day-to-day management functions to a management

committee or similar body. Not every member might be a member of such committee.

5.4 This may produce anomalous results. An executive working for Firm A (an investment bank or PE manager structured as a limited company) might not fall to be treated as Remuneration Code staff but would be so treated at Firm B (which happens to take the form of an LLP) even though the amount of his remuneration is the same, he has no more management responsibility and takes no greater risks on behalf of clients.

5.5 The definition of Remuneration Code staff should not refer to significant influence function holders. It should be for each firm to conduct a proper assessment of which staff conduct professional activities that materially affect the firm's risk profile and therefore constitute Remuneration Code staff.

5.6 *Definition of "remuneration"*: We do not think that distributions of profit by an LLP or LP should be treated as "remuneration" at all, on the basis that they represent a return on investment. Distributions of profit are not remuneration from an economic or tax perspective. We have alluded to this point in paragraph 4.1 above, but the point is particularly important and compelling where the firm is structured as an LLP or LP (as opposed to a limited company). Clear guidance on this is needed. At the very least, there must be a recognition that not all payments of profits to all members are automatically remuneration within the meaning of the Code. Firms must be given the opportunity to justify their proposed treatment of profit distributions.

5.7 To the extent that a distribution of profit is caught, presumably the element represented by monthly drawings (salary-equivalent) should be treated for the purposes of the rules as fixed (as opposed to variable) even though it will almost certainly be contingent on the LLP making profits in the current year sufficient to support it and similar distributions to other members. Profits are by definition not guaranteed and not fixed. Applying rules which require appointment between fixed and variable makes no sense for owner-managers.

5.8 *Tax timing problems:* The draft principles which require deferral of a proportion of variable remuneration create tax timing problems for firms structured as LLPs. LLPs are tax transparent for UK purposes. All profits must be taxed in the hands of an LLP's members in the year in which they arise (even if such profits are not distributed). To the extent an LLP is required to defer distribution by the Code, it is not possible for its members to defer their own obligation to pay tax in respect of the deferred amount. Accordingly, the application of the revised Code would result in the LLP's members having an unfunded tax liability.

5.9 *Remuneration Principle 6:* For the same reason, it is very difficult to apply Remuneration Principle 6 (remuneration and capital) to an LLP: for tax reasons, it is difficult for an LLP to build up audited retained profits which would count as tier 1 capital. We understand from our meeting that the intention of Principle 6 is to prohibit a firm from taking active decisions in relation to remuneration which it knows at the time will prejudice its capital position. This should be made express in guidance.

5.10 *Share-based payments:* We refer to paragraph 1.16 above concerning share-based payments

in private groups. It is difficult to see how an LLP could ever hope to establish a traditional share incentive scheme. The legal structure of an LLP does not accommodate any such concept, which is more naturally applicable to large companies with marketable shares or other securities, not partnership interests.

5.11 *Conclusion:* We would encourage the FSA to address the particular problems faced by LLPs, LPs and common law partnerships through additional guidance in the Code, together with commentary in the policy statement. Guidance might turn on the CRD3 requirement to apply the remuneration provisions proportionately to the firm's internal organisation. If the FSA is concerned about treating LLPs differently from other legal vehicles, then we suggest that similar results might be achieved by adapting the rules for owner-managed businesses, whatever their legal form.

6. Other aspects of proportionality

6.1 There are other bases (apart from those set out in section 1 above) on which some PE and VC firms might conclude:

6.1.1 that it is disproportionate to comply with the Principles set out in the FSA's Proportionality Table 3; and

6.1.2 that it is appropriate to take the approach to compliance with the principles suggested in the FSA's Proportionality Table 2. We describe these in sections 6.2 to 6.4 below.

6.2 *The firm's size*: The vast majority of PE and VC managers 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 PE and VC firms should be able to take the approach described in paragraph 6.1 above (even if they do not operate carried interest and co-investment arrangements) provided that they: (a) comply with the mandatory rules in Proportionality Table 1; and (b) they have robust arrangements for identifying, avoiding and managing conflicts of interest in accordance with SYSC 10, Capital Markets Bulletin Issue 3 and Remuneration Principle 3.

6.3 *The firm's internal organisation:* We believe that this factor is likely to work in combination with the smaller size of many PE and VC managers. A typical feature of these firms is that they operate very flat organisational structures. There is typically very active and close engagement by the principals in every transaction arranged for the fund. Typically, any investment decision must be made by a formal investment committee including principals and selected other senior investment executives. These structures reduce operational and legal risks facing the firm, as well as the risk of dissatisfying investors.

6.4 *The nature, scope and complexity of the firm's activities.* This paper makes many references to the nature of a PE or VC asset management business.

7. Segregation of functions

7.1 The two factors of size and internal organisation will also make it difficult for some PE and VC firms to apply some of the draft rules and guidance on segregation of functions. We note that several pieces of draft guidance and evidential provisions are both super-equivalent to CRD3 (contrary to our understanding of the UK Government position on "goldplating") and are designed with large multi-function banks and investment banks in mind. Those provisions should be deleted, as it is questionable that they deliver benefit to any investment manager, whatever its size and structure. At the very least, express reference should be made to the fact that the guidance and evidential provisions may be of limited application to smaller firms and/or firms with simpler businesses and organisational arrangements.

7.2 In particular:

7.2.1 SYSC 19.3.15E (1) and (2): It will typically be inappropriate for risk management and compliance staff in investment firms, in particular small ones, to have input into remuneration awards. Some small firms might have only one or two principals, with the finance, risk management and compliance function performed by an employee. It is artificial and disproportionate to require the holder of controlled functions 10 (compliance oversight) and 11 (MLRO) to have a significant influence on remuneration of the owners of the business. The regulatory risk in this regard is mitigated by the fact of total transparency and short reporting lines, and the senior management responsibility of the principals (one of whom is likely to be the CF3 chief executive and all of whom will be approved persons).

7.2.2 SYSC 19.3.17G(1) and (2): It may be impossible in some firms to segregate control functions and human resources. In some firms, these functions will be performed by the same principal. For firms with few employees the concept of a separate HR function is unthinkable.

7.2.3 SYSC 19.3.17G(3) requires the ratio of the potential variable component of remuneration to the fixed component to be significantly lower for employees in risk management and compliance functions. This would be incapable of application to firms where in very small firms one of the principals performs some risk management and compliance functions, as well as some front office investment functions.

8. Clarity: the need for appropriate tailoring and legal certainty: the limits of supervisory discretion

8.1 We note that the FSA's current Remuneration Code applies to the 27 largest UK banks, building societies and investment banks. The FSA estimates that the extended Code will apply to over 2,500 firms. We believe that it could affect an even greater number of firms to some degree from 1 January 2011 by virtue of the anti-avoidance rules concerning groups. Because of the AIFM Directive, remuneration rules will in due course affect an even larger

constituency, including the vast majority of the BVCA's member firms. There is an important consequence of this dramatic extension of scope:

8.2 It is vital that the final form of the Code is appropriate to, and provides legal certainty for, the large numbers of firms in scope. It must be clear on its face:

8.2.1 which firms it affects: the Code should reflect and be capable of application by the range of firms within its scope and recognise that investment managers and, in particular, PE and VC investment managers, are not banks and the issues of risk management in such entities are entirely different to those in banks.

8.2.2 which individuals in those firms are to be treated as Remuneration Code staff;

8.2.3 which aspects of their remuneration and of their investment returns (if any) are caught;

8.2.4 as to the limits of proportionality.

8.3 We say this because, in the case of most firms, the FSA will be unable to rely on supervisory discretion in relation to the application of the Code. Clarity of application is therefore paramount. Whereas the 27 institutions currently in scope are likely to be subject to close and continuous supervision by dedicated FSA teams, those newly affected will have far less access to the FSA and far fewer supervisory resources available to them. We anticipate that, from 1 January 2011, between 20 and 30 PE managers will come into scope. Some but not all of these will have a limited supervisory relationship with the small private equity supervisory team. On implementation of the AIFM Directive, the vast majority of affected firms will have access only to the Firm Contact Centre. It would be a bizarre result if the smaller non-bank firms were effectively treated more harshly because they, who present much less risk to the financial infrastructure, are subjected to unnecessarily onerous and unclear rules with the attendant legal risk, as only the largest institutions benefit from a supervisory dialogue.

8.4 The fact that there are to be provisions on voiding and recovery means that it will be extremely high risk for firms to settle on their own reasonably prudent interpretations of the Code, without supervisory interaction. In the absence of resources at the FSA to handle this, firms may need to lean heavily on legal and compliance advisors, which will push up costs dramatically. Even that will not remove the voiding risk. We believe that the FSA's Cost-Benefit Analysis significantly underestimates one-off and ongoing costs for this reason.

9. Voiding provisions

9.1 We note the FSA's power under the Financial Services Act 2010 to void contracts.

9.2 The draft rules on voiding and recovery in SYSC 19.3.51R et seq and Annex 1 are extremely blunt. We consider that they require substantial revision in order to provide legal certainty. This is not a point specific to the PE and VC industry and we imagine it is one on

which others will respond in greater detail.

9.3 Nevertheless, we have identified in this response a number of points on which the draft Code does not yet provide clarity. Whilst we hope that the FSA will address our concerns (and we are encouraged by and grateful for the FSA's approach to date), it is unlikely to be possible to resolve each and every one of our concerns in a way that gives complete certainty to firms. Yet it is proposed that any provision of an agreement that contravenes the Code is automatically to be rendered void. Moreover, the firm must take reasonable steps to recover payments.

9.4 The voiding provision has the potential to operate not only on bilateral contracts of employment between a firm and its employee but also on multipartite contracts, such as partnership documents which govern carried interest and co-investment arrangements (see Part D below).

9.5 Those contracts may well be governed by laws other than those of the United Kingdom and the effect on such contracts will be unclear.

9.6 For those reasons, we strongly urge the FSA to choose not to exercise its power to void contracts in relation to contracts pertaining to employment with investment managers or documentation in connection with such employment (for example carry and co-invest documentation)

9.7 We reserve our position as to whether the provisions are compliant with the Human Rights Act 1998.

10. Timing and grandfathering

10.1 *We state our position on the issue of proportionality and carried interest and co-invest schemes in the paragraphs above. The comments below are only relevant to the extent if at all that the FSA is unwilling to accept that position.*

10.2 We understand the effect of the draft Code to be that, for firms not subject to the existing Code, any distribution from a carried interest or co-investment scheme in which the right to participate was awarded and taken up on or before 31 December 2010 is not affected by the Code. We understand that any such right awarded and taken up between 1 January 2011 and 30 June 2011 inclusive will be subject to the transitional provision in draft SYSC 19 TP3. Confirmation of this will provide critical certainty for firms.

10.3 Paragraph 4.50 of the consultation paper sets out the FSA's expectation that firms will take reasonable steps to amend or terminate arrangements that are inconsistent with the revised Code. In most cases, the concept of amendment or termination would significantly interfere with arrangements (current and historic) which have already been settled with investors, thus affecting more persons than just the firm and its employees and leading to the need to renegotiate, in respect of all relevant schemes, with investors, which is completely impracticable. We invite the FSA to reconsider its position on this in its policy statement.

11. Public disclosure of remuneration

11.1 We understand that there is no present proposal of the UK Government or the FSA to require the public disclosure of remuneration awarded by any investment management firms under section 4 of the Financial Services Act 2010. We would welcome further information about the FSA's intentions with regard to public disclosure required by CRD3, and the application of proportionality in that context. We suggest 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.

12. Systems and controls rules

12.1 Draft SYSC 19.3.35G provides that non-financial performance metrics should form a significant part of the performance assessment process and should include adherence to effective risk management and compliance with the regulatory system etc. Whilst we support this concept in principle, we think the words "to the extent relevant" must be inserted into the first line of SYSC 19.3.35G to reflect the extent to which there are rules applicable to any given function.

13. Other technical problems

13.1 For reasons similar to those set out in section 4 above, the obligation under Principle 6 to avoid remuneration payments that could inhibit the firm's ability to strengthen its capital base has limited relevance to the activities of many PE and VC managers. They are investment managers, not investment banks or broker dealers, and the activities of their executives and the related remuneration structures reflect this and do not impact on or result in the need to strengthen the capital base. A typical private equity firm's reputation, value and ability to raise its next fund are all dependent upon the performance of its current fund(s). For many PE firms, it is reputational capital (in the form of track record) rather than financial capital which ensures continued success. Many PE firms can actually survive and thrive on a very limited capital base. The regular management fee received by firms means they have a predictable income stream that is settled for a fixed period, against which to plan their expenditure.

13.2 We do not understand the intention of the second sentence of SYSC 19.3.47G(2) (which we note is super-equivalent to CRD3) and we would welcome clarification of this in the policy statement please. We do not understand it to suggest that "particularly high amount" is a relative term applicable subjectively to each firm (which would produce perverse results).

13.3 We are concerned by the second limb of Remuneration Principle 8 (draft SYSC 19.3.22R9(2)). What is intended by the requirement to ensure that the allocation of variable remuneration components within the firm takes into account all types of current and potential risks? We cannot see what this adds to the rest of the provisions and suggest it is either deleted or explained.

13.4 We do not understand what is meant in draft SYSC 19.3.46R by deferral "over a period which is not less than three to five years". Is it permissible for a proportion of the amount deferred to vest in the first year, providing that the whole amount does not vest sooner than three years? This provision needs clarification.

14. Interaction between CRD3 and the AIFM Directive

14.1 The remuneration provisions of CRD3 are a prudential measure. Those provisions were designed with large multi-function institutions in mind. The European law is insufficiently adapted to many investment firms, including investment managers and, in particular, PE and VC managers. The FSA is obliged to make the best of this on UK implementation of CRD3 but it is a topic on which we also plan to engage with CEBS.

14.2 Recent drafts of the AIFM Directive make provision for pay regulation modelled substantially on CRD3. We appreciate that there is still no political agreement on the final form of the AIFM Directive at Level 1. We support suggestions which have been made (including by representatives of the AMF) that the text in draft Annex II to the latest compromise text (put forward by the Belgian Presidency of the Council) should be deleted from the Level 1 measure, so that detailed rules taking account of the specific characteristics of private equity and other alternative investment fund business models can be developed in Level 2.

14.3 Assuming that change cannot now be achieved, we place significant reliance on the repeated references in the text to the need to apply the remuneration principles "in a way and to the extent [our emphasis] that is appropriate to [the] size, internal organisation and the nature, scope and complexity of [the AIF's] activities". Whilst there are some differences in the detail of the draft AIFM Directive text and the CRD3 provisions on remuneration (and we note in this response where they arise), we believe that the AIFM Directive text gives the FSA the same opportunity to adopt a comply or explain approach, as did recital 4 to CRD3.

14.4 We recognise that the AIFM Directive is a measure specifically targeted at alternative investment fund managers. This is reflected in some points of detail where the AIFM Directive text departs from CRD3. Notably:

14.4.1 the application of the principles to staff whose professional activities have a material impact on the risk profile of the AIF they manage (as well as on the AIFM); and

14.4.2 the substitution of provisions on share-based payments with references to variable remuneration taking the form of units or shares of the AIF – which language still demonstrates an imperfect understanding of the positive features of existing reward structures; and

14.4.3 specific references to "carried interest" (as therein defined).

14.5 Nevertheless, we believe that the points we make now on the application of pay regulation

to PE and VC will have very significant resonance on UK implementation of the AIFM Directive.

Part C: Response to Cost-Benefit Analysis

15. Underestimate of incremental compliance costs for investment managers

15.1 *CBA paragraph 4:* It is important that the FSA should obtain empirical data from firms that incurred the actual costs of compliance with CP09/10 and that these actual costs should be referenced against the CBA for CP09/10. We would be grateful to know whether this has been done please.

15.2 *CBA paragraph 7:* It will be critical that the proportionality principle is properly applied since disproportionate application will cause a commensurate increase in compliance costs.

15.3 *CBA paragraph 10:* If the proportionality principle is applied on the basis of increased supervision, our view is that the costs to the FSA as regard FTEs and training are a material underestimate given the application of the proposals to 2554 firms.

15.4 *Incremental compliance costs incurred by firms*

CBA paragraph 13: Query if these are "incremental costs" when in fact most firms will face new costs because they are having to comply for the first time. They are incremental for firms currently in scope.

CBA paragraphs 22 to 24: Changes to governance, training and annual remuneration statements do not take account of the opportunity costs as regards senior management time.

15.5 *Adjustment of remuneration structures*

CBA paragraph 27: Changes to structures are an absolute requirement therefore there will be an associated costs. It seems odd to express this as a possibility.

CBA paragraphs 28 to 30: The cost base increase resulting from the shift to higher fixed salaries will be enormous. This will reduce profitability and therefore shareholder distributions. It seems to be counter-intuitive that shareholders get a worse deal and there is a move away from performance based variable pay.

16. Frame of reference

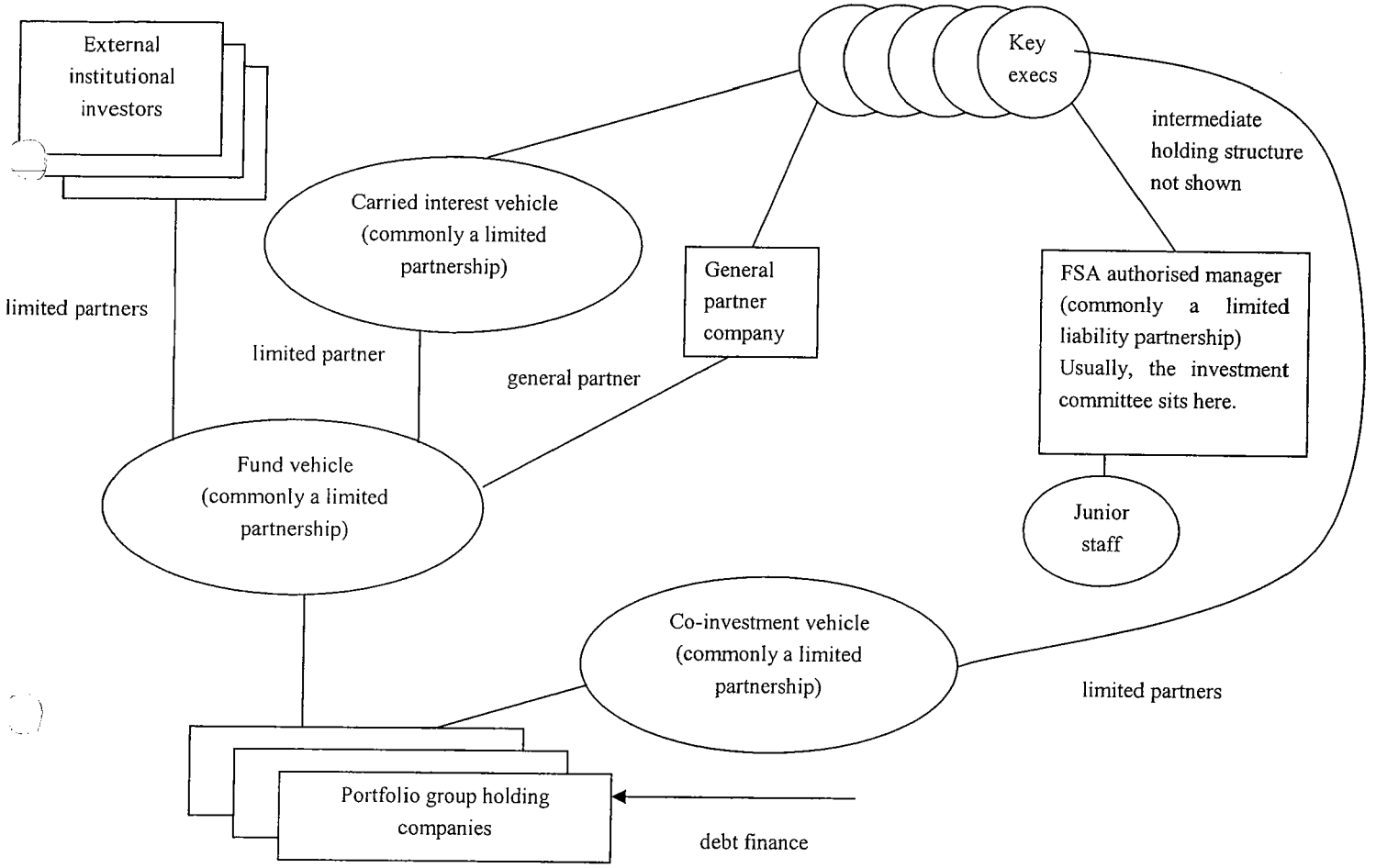
16.1 It appears to us that the CBA has failed to take any account of the potential costs of adjusting remuneration structures which form part of anything other than a straightforward employment arrangement including entitlement to fixed base salary and discretionary or contractual bonus. More sophisticated reward structures, including carried interest and co-investment arrangements are documented in sophisticated multi-partite legal agreements that often involve outside parties and are subject to approval and/or agreement by investors. The possibility of adjusting or voiding arrangements is a threat to the legal principle of personal contracts that are privately negotiated and associated risk of legal action.

Part D: Description of Private Equity and Venture Capital Incentive Structures

17. Note

17.1 Please note that the diagrams and descriptions in this part of our response are illustrative only. Not all firms operate in the same way. We intend this part of our response to give an overview of the type of structures and arrangements which exist. It is not and could not be a definitive description of them.

18. Example legal structure for a UK-headquartered PE firm



19. Common variations on legal structure

19.1 The diagram in section 17 above describes a typical legal structure for a UK-headquartered PE firm.

19.2 There are very many possible variations on this structure. Common variations include:

19.2.1 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.

19.2.2 Establishing the fund vehicles offshore the UK, commonly in the United States or Guernsey, Jersey or another tax neutral jurisdiction.

19.2.3 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.

19.2.4 The investment manager can be an LLP or a limited liability company.

19.2.5 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.

19.2.6 Establishing the investment manager offshore the UK.

19.2.7 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.

19.2.8 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.

19.2.9 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.

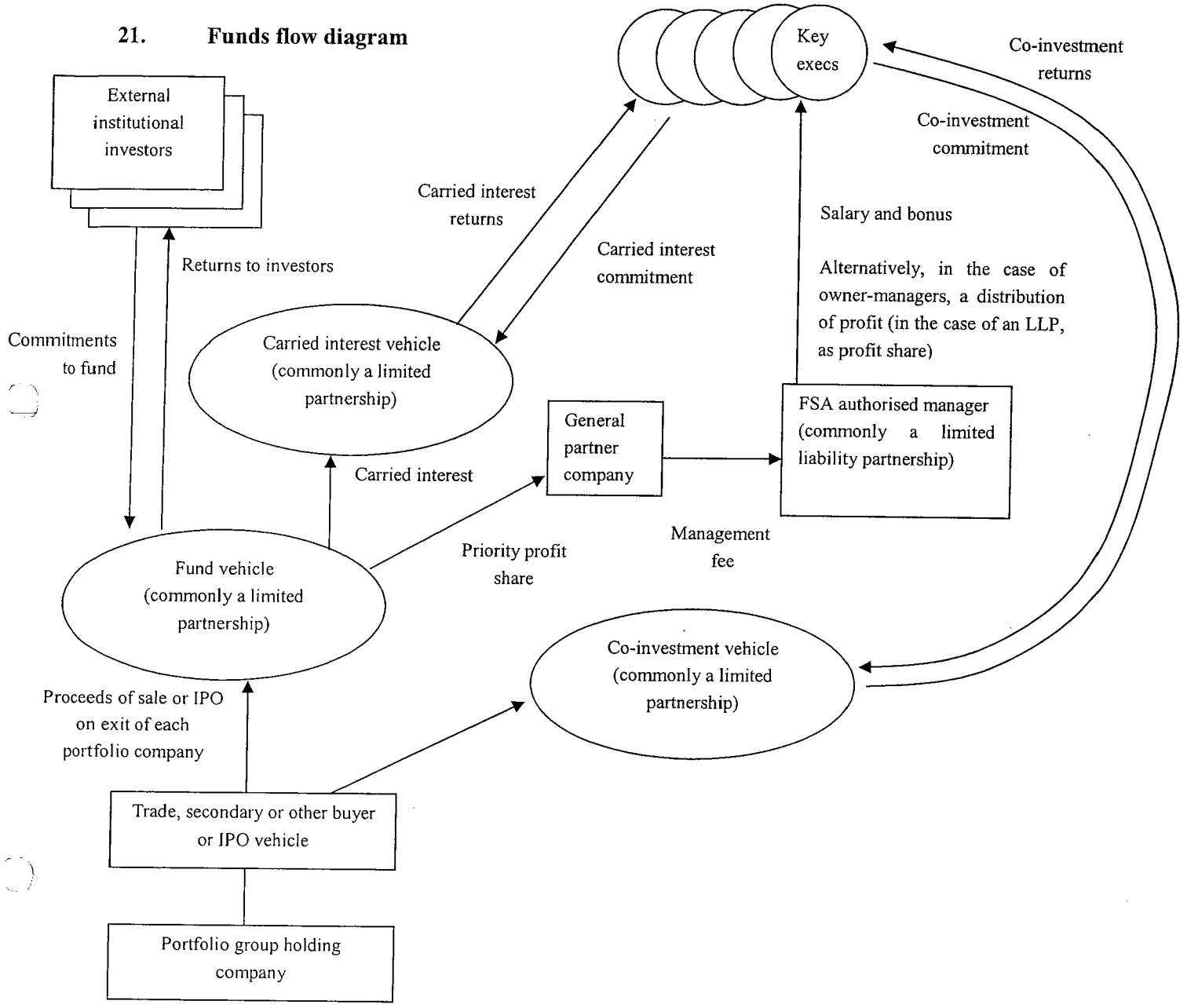
19.2.10 Junior and mid-ranking staff may be employed and remunerated by a group service company, with the staff made available to the investment manager on a secondment or similar basis.

20. Regulatory categorisation of the investment manager

20.1 Many BVCA member firms fall within the exemption in Article 2(1)(h) MiFID. The arrangements maintained by other PE and VC firms are more complex and give rise to categorisation as a CAD investment firm and, specifically, as a BIPRU limited licence firm

for UK purposes.

21. Funds flow diagram



21.1 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).

21.2 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.

21.3 The general partner uses the PPS to pay the annual management fee on behalf of the partnership to the investment manager.

21.4 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.

21.5 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.)

21.6 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).

21.7 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.

21.8 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.

21.9 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.

22. Carried interest

22.1 Carried interest, and often co-invest, is required and negotiated by the fund investors and

follows quite predictable fund investors norms. The key features of carried interest arrangements relevant to FSA remuneration policy are as follows:

22.1.1 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.

22.1.2 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.

22.1.3 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.

22.1.4 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.

22.1.5 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.

23. Co-investment

23.1 The typical features of co-investment arrangements relevant to FSA remuneration policy are as follows:

23.1.1 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".

23.1.2 Team members within the PE firm invest their own money alongside the fund and on the same economic terms as the investors.

23.1.3 In other words, they put at risk the loss of their own money through their stake.

23.2 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.

Part E: Data on Private Equity and Venture Capital Incentives

24. Thanks

24.1 We are grateful to MM&K, strategic pay and reward consultants for the provision of raw data on which we have drawn in this part of our response. www.mm-k.com

25. Notes on data

25.1 The information provided by MM&K:

25.1.1 is sourced from firms in a number of market sectors (Very Large Buy-out Groups; Large Mid Market Buy-out Groups; Smaller Mid Market Buy-out Groups; and Venture/Seed Capital Groups);

25.1.2 covers the key carry-eligible population (i.e. individuals with the titles CEO/Managing Partner, Senior Partner, Partner, Director and Associate);

25.1.3 includes (largely) market median data on base salary (correct as at 1 July 2009), total cash (i.e. salary plus annual bonus), and carried interest (but excludes amounts received by the two most senior roles as partnership profit share);

25.1.4 in referring to total cash data includes bonuses paid in respect of the performance year ending between July 2008 and June 2009. Therefore, depending upon the exact timing of a firm's financial year end, their bonuses will have been impacted by the financial crisis to a lesser or greater extent, with some firms paying zero bonuses at some levels.

25.2 The carried interest information reflects the carried interest scheme participant's interest in the most recent fund raised by the firm. This is known as the individual's "carry working" 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.

25.3 Clearly, many funds will not perform at this level and others will not produce any carry distributions at all (as they will not meet the industry standard performance hurdle of an 8% p.a. investment rate of return). BVCA data suggests that about 20% of currently active funds are likely to make carried interest distributions (which figure reflects in part the financial crisis affected currently active funds).

25.4 Funds raised typically have a 4 or 5 year investment period, and therefore the participants' "carry working" has been divided by 4.5 to produce annualised figures.

26. Typical relationships

26.1 Salary and annual bonus

26.1.1 In order to provide some sense of the relationship between the components of total cash (being salary and annual bonus), we have expressed the median salary reported as a percentage of the median total cash figure. This is not perfect as the individual who represents the median on base salary will not be the same individual who represents the median on total cash. However, it should nevertheless give some sense of the make-up of a typical reward structure in the PE market.

26.1.2 Whilst the salary percentage appears (at 45-58%) to be lowest for the very top job level in most buyout firms (as one might expect), no strong pattern is evident at lower job levels – where salary represents anywhere between 48% and 84% of total cash. This lack of obvious pattern may be partly driven by the fact that many firms chose in this particular year – when bonus funding was limited – to skew the available bonus monies more than usual towards their more junior population. However, MM&K have confirmed that any such job level related pattern was also relatively weak in the market data for the previous two years.

26.1.3 A more pronounced pattern emerges when the data is analysed by market sector. It would appear that salary represents c.70-75% of total cash in the Venture Capital and the Smaller Mid Market Buyout Groups, but only around 50-55% of total cash in the Large Mid Market / Very Large Buyout Groups.

26.2 Salary, annual bonus and annualised carry working

If we include annualised carry working in our analysis (see paragraph 25.2 above for explanation), it would appear that:

26.2.1 carry represents c.73% of the total incentive in Venture Capital Groups, c.79% in the Smaller/Large Mid Market Buyout Groups, and c.82% in the Very Large Buyout Groups; and that

26.2.2 carry represents c.72% of the total at the most junior job level, and c.85% at the most senior.