Madaliso Zgambo,
Department for Work and Pensions
Policy Group, Private Pensions and Arm's Length Bodies Directorate
Third Floor South, Quarry House
Leeds, LS2 7UA

By email: pensions.charges@dwp.gov.uk

20 August 2020

Dear Madaliso,

**Re: BVCA response to DWP consultation on the review of the default fund charge cap and standardised cost disclosure**

We are writing on behalf of the British Private Equity and Venture Capital Association (BVCA), the industry body and public policy advocate for the venture capital and private equity industry in the UK. We represent the vast majority of all UK-based firms (over 750), as well as their professional advisers and investors. The UK has a dynamic and professional venture capital and private equity ecosystem which continues to be the second biggest hub worldwide. The right policy interventions will support continued long-term investment into businesses by the UK's venture, growth capital and private equity industry.

Our members raise capital and deliver strong returns for institutional investors (including some UK institutions) such as pension funds, endowments, sovereign wealth funds, funds of funds and insurance companies. These returns contribute not only to the growth and stability of UK-based institutions themselves, but ultimately to their beneficiaries such as pension savers and consumers of insurance products.

**Summary feedback**

The BVCA has contributed to previous government initiatives and consultations reviewing the barriers preventing pension savers in UK defined contribution ("DC") plans from investing in long-term, illiquid assets and benefiting from the resulting returns. These returns have been available to UK defined benefit ("DB") scheme participants for decades and research (covered below) has demonstrated that the asset class outperforms public/listed equities. There is ever-increasing demand for private capital to support the growth of UK businesses, particularly at the venture and growth stages of their development, and we note the disproportionate role that capital from non-UK pension funds currently plays in meeting that demand (less than 5% is raised from UK pension funds by BVCA members fundraising from the UK). It is currently easier for members of overseas pension schemes to invest in UK private equity and venture capital funds than it is for members of UK DC pension schemes.

The calculation method for the 0.75% charge cap applied to the default arrangements of DC pension schemes should not treat profit sharing models such as carried interest as a performance fee. A precedent for this exists in the rules applied to Israeli DC schemes. Whilst we understand the rationale for the cap, it is also a key barrier. This is because it does not accommodate long-term incentive models such as carried interest that benefit both investors' returns and the growth trajectory of the companies our industry invests in. A lowering of the cap would make it much more

difficult, if not impossible, for DC pension schemes to invest in the asset class due to a combination of the inclusion of carried interest in the cap, and the higher costs associated with managing venture capital and private equity investments.

The BVCA has for many years led efforts to improve transparency in the venture capital and private equity industry. The BVCA is a Cost Transparency Initiative ("CTI") board member and was involved in the FCA disclosure working group. Detailed reporting on fees and carried interest earned by fund managers is sought by investors and the industry provides this information through a variety of standards and templates. These requests vary due to the international investor base of UK funds.

Whilst we recognise the benefits of standardised templates, the reality is that a variety will continue to exist because of our industry's international investor base, where larger investors can demand bespoke reporting formats. We therefore believe legislative intervention is not required to mandate the use of the CTI templates specifically, as the venture capital and private equity industry does report regularly on fees and costs and to the same standard as the CTI templates, albeit in different formats.

Finally, we note the progress that the US has been making towards levelling the playing field between its DB and DC savers. The US Department of Labour has confirmed[1] its view, with the support of the SEC and much of the US pension fund industry[2], that a DC fiduciary "may properly select an asset allocation fund with a private equity component". The DOL guidance is not a blanket green light to DC investment in private equity funds, and notes a number of safeguards, such as a requirement that the majority of the investments of any vehicle designed to allow private equity and venture capital exposures should remain in liquid assets. However, the direction of policy in the US reflects the SEC's recognition that the removal of barriers to DC schemes gaining (regulated) access to private equity and venture capital funds may "enhance retirement savings and investment security for American workers". This is a positive step for the retirement prospects of pension savers, and one that the UK should urgently emulate.

## Response to consultation questions

We have responded to the questions in the consultation most relevant for investment into venture capital and private equity funds.

### *Chapter 3: The level of the charge cap*

**Q5. If we lowered the cap, what would be the impact on (a) scheme member outcomes (b) industry?**

The cap is preventing DC pension schemes from accessing venture capital and private equity as the calculation method treats carried interest as a performance fee. This approach means that schemes could breach the cap and so there has been little investment into venture capital and private equity by DC pension schemes in recent years. To accommodate the cap, significant scale, an in-house team, and a mature established portfolio of direct investments (rather than investments via funds) is required. This is not a viable option for smaller firms.

[1] See DOL letter of information dated 3 June 2020: https://www.dol.gov/sites/dolgov/files/EBSA/about-ebsa/our-activities/resource-center/information-letters/06-03-2020.pdf
[2] See footnote 1 of the above letter.

The level of UK pension funds investment overall (including DB funds) into venture capital and private equity funds raised from the UK has been low in recent years:

| **BVCA data on venture capital & private equity fundraising[3]** | | | | | | | |
|---|---|---|---|---|---|---|---|
| Type of source | Location of investors | 2017 | | 2018 | | 2019 | |
| | | £m | % | £m | % | £m | % |
| **Pension funds** | UK | 1,224 | 4% | 1,196 | 4% | 951 | 2% |
| | Overseas | 12,032 | 36% | 12,072 | 35% | 16,921 | 36% |
| | Unclassified | | 0% | | 0% | 65 | 0% |
| **Other sources** | UK | 4,796 | 15% | 3,551 | 10% | 4,414 | 9% |
| | Overseas | 14,937 | 45% | 17,299 | 51% | 24,727 | 52% |
| | Unclassified | - | 0% | - | 0% | 519 | 1% |
| **Grand Total** | | **32,989** | **100%** | **34,118** | **100%** | **47,597** | **100%** |
| | Number of firms fundraising | **50** | | **60** | | **74** | |
| | Number of funds | 79 | | 94 | | 118 | |

This position should be contrasted with the early days of venture capital and private equity in the UK in the 1980s and 1990s when the DB pension plans of organisations such as the Coal Board, British Gas, Unilever and the Prudential, to name but a few, were major investors in UK funds.

***The 'illiquidity premium' in venture capital and private equity***

A lowering of the cap would make it more difficult, if not impossible, for DC pension schemes to invest in the asset class. This is a missed opportunity to benefit from the strong performance generated by venture capital and private equity funds, as well as constructing a more diversified portfolio. Research over recent years has demonstrated how the asset class outperforms public/listed equities.

- A report by the British Business Bank and Oliver Wyman in 2019[4] found that retirement savers in defined contribution pension schemes are missing out on higher returns from venture capital and growth equity. Retirement savings could be increased by 7-12% for a 22-year old, for example, if their DC pension scheme made 5% of investments in the UK's fastest growing and most innovative companies.

- Academic research from Gregory Brown (UNC Kenan-Flagler Business School) and Steven Kaplan (University of Chicago Booth School of Business) in 2019[5] compared the annualised returns (internal rate of returns, IRRs[6]) and the Kaplan-Schoar (2005) public market equivalents (PMEs) by vintage year of global buyout, venture, growth, and generalist private equity funds against the contemporaneous total returns of the MSCI All Country World Index. The returns have been higher than the MSCI and the PMEs are greater than one for every single vintage year.

[3] BVCA Report on Investment Activity. Fundraising includes GP commitment, EIS and VCTs. UK includes British Overseas Territories and Channel Islands. https://www.bvca.co.uk/Research/Industry-Activity

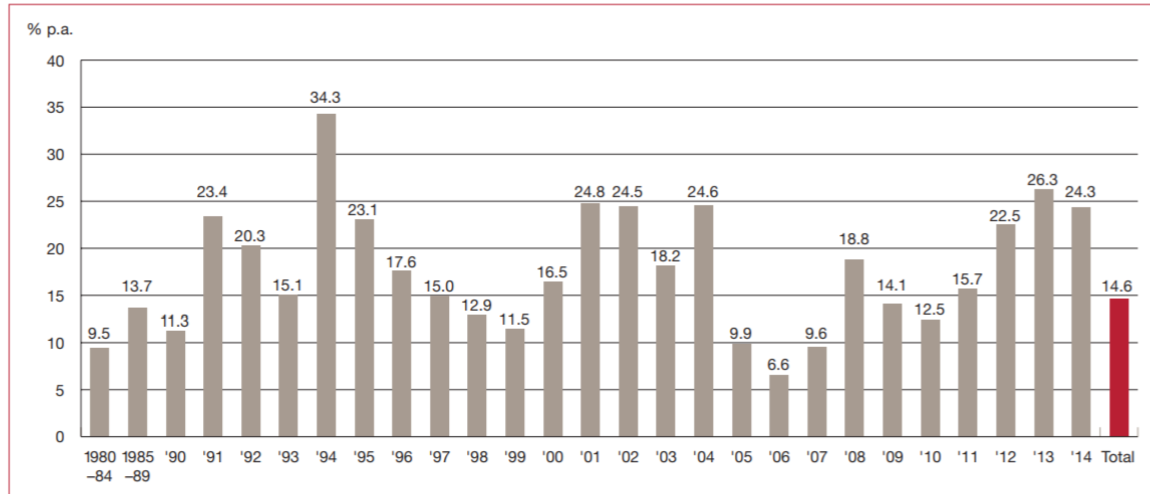
[4] https://www.british-business-bank.co.uk/research/the-future-of-dc-pensions-enabling-access-to-venture-capital-and-growth-equity/

[5] https://kenaninstitute.unc.edu/publication/have-private-equity-returns-really-declined/

[6] IRR calculates the average annual return of the investment by looking at all of the cash flows from the investment over a given period, taking into account possible capital gains and income through dividends. By expressing returns as an annual percentage of investment rather than as an absolute return, IRR allows investments with differently timed and sized cash flows to be easily compared.

- The annual BVCA Performance Measurement Survey[7] shows UK venture capital and private equity funds continue to demonstrate, on a since-inception basis, a high level of consistency in performance returns. Returns are net of all fees and costs, including carried interest.

Since Inception Return by Vintage Year to December 2018




- In its 2020 Public Pension Study[8], the American Investment Council examined the investments and returns of America's largest public pension funds (many of which invest in UK funds - overseas public pension plans are large investors in the BVCA data set above). Private equity was once again the best performing asset class for public pensions, delivering a median annualized return of 13.7 percent over a 10-year period. All returns are net of fees and carried interest.

- The Bain & Company Global Private Equity Report 2020[9] also showed that buyout funds have continued to outperform public equities (see figure 1.28).

In addition, research on risk in private equity carried out by Montana Capital Partners and the BVCA[10] has found that across a diversified portfolio of fund investments, the risk of losing capital can be brought down below 1%, and that levels of funding risk become predictable and manageable. In addition, the research also shows that for a suitably diversified portfolio of fund investments, the risk of an investment not being able to realise its valuation can be brought below 1%.

***Carried interest is a mechanism for long-term alignment and not a regular performance measure***

The charge cap's formulation, both currently and under the proposals from the DWP's 2019 consultation, presents an insurmountable obstacle for DC schemes wishing to invest directly into traditional venture capital and private equity funds, as well as many other types of private capital funds (e.g. alternative lending/debt funds). The cap does not accommodate carried interest which is an essential feature of the venture capital and private equity model.

[7] https://www.bvca.co.uk/Research/Industry-Performance
[8] https://www.investmentcouncil.org/what-they-are-saying-private-equity-delivers-robust-returns-for-public-pension-beneficiaries/
[9] https://www.bain.com/globalassets/noindex/2020/bain_report_private_equity_report_2020.pdf
[10] https://www.bvca.co.uk/media-and-publications/news/bvca-press-releases/details/How-risky-is-private-equity

The timing and amount of carried interest distributions is uncertain as it is directly linked to the performance of a venture capital or private equity fund's portfolio taken as a whole, which is typically only established once most of the portfolio has been sold. Crucially, for DC pension schemes, this also means that carried interest cannot meaningfully be measured on an ongoing basis for the purposes of the charge cap. As carried interest distributions are variable in line with the realisation/sale of investments, their timing and value cannot be accurately predicted in advance. Furthermore, as the management fee and carried interest allocation is calculated on a different base to the charge cap i.e. it is not on the value of assets managed, it is not possible to know in advance the amount of either management fee or carried interest as a proportion of the value of assets managed.

We understand the policy rationale behind the charge cap in the context of funds with liquid assets. However, as we explain below, carried interest is a profit share, as opposed to a cost, which is only paid after investors' capital is repaid in full (in cash), with a preferred return in addition to that repayment, and as such causes no risk of erosion of investors' capital. Carried interest distributions signal a fund is performing well for its investors. Including it in the charge cap incentivises a short-term focus on costs, which is anathema to venture capital and private equity's long-term focus on absolute net returns. We believe the DWP should encourage DC schemes to consider overall net returns when investing in illiquid assets over the long term.

We have included an Appendix setting out the structure, function and effectiveness of carried interest arrangements in greater detail. Funds in this industry are typically closed-ended, and this response is restricted to that type of structure. Market practice regarding the basic carried interest model has not changed significantly for the past thirty-five years. This fact in itself demonstrates that investors consider carried interest a fair and effective method of aligning the interests of the fund manager and fund investors, and of driving the strong returns that the venture capital and private equity industry has consistently delivered.

Carried interest, as its name suggests, is a participating interest in a fund awarded to a manager at the inception of the fund with the potential of increasing in value in line with the performance of the overall portfolio. It comprises a right for the manager to participate in fund economics alongside investors rather than a legal obligation on the fund to pay a fee from time to time.

Carried interest distributions are not typically received by a fund manager until after the fund has generated enough cash returns from the sale of portfolio companies to pay back all of the investors' invested capital (including amounts drawn down to cover the fund's management fee/priority profit share and other expenses of the fund) plus a preferred return or 'hurdle' (of typically 8% p.a.). This is a profit share, which the fund manager only receives once the fund is already successful, i.e. the risk of any loss to investors has been eliminated, and the negotiated benchmark return to investors has been exceeded.

This arrangement has arisen because the performance of a venture capital or private equity investment depends heavily on the amount and quality of the portfolio management work that the fund manager does after it has made the investment decision (as well as having made a good initial investment decision). This work helps the company fulfil its initial promise and strategic plans, grow in value and thereby provide returns based on capital appreciation to the fund's investors when the company is sold, usually at the conclusion of a three to five year business plan (or longer in the case of some patient capital funds) put in place on investment.

It is critical to both fund managers and investors that a fund manager is incentivised to continue to work hard, for many years after the investment decision, to increase the value of the fund and its investors' capital by exercising the fund's ongoing influence over the company (or very often

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control, as the majority shareholder). This is why carried interest in the traditional UK/European fund model does not unconditionally[11] reward fund managers with any share of a fund's profits of a fund until the fund manager has returned investors' capital plus the preferred return. Further performance is eventually rewarded as a minority share of the fund's further profits once investments have been realised, if, and only if, the investment decisions, and subsequent multi-year effort of the fund manager in growing the businesses in the fund's portfolio, have succeeded in returning the entirety of investors' capital and delivering them the agreed preferred return.

This is radically distinct from how performance fees work in other types of investment fund. In other contexts, a fund manager's reward is often based on the ongoing market or other benchmark performance of the assets that a fund manager has selected, based on current portfolio valuation. Such benchmarks do not exist for private markets, but would in any case remain inappropriate for illiquid assets whose ultimate performance depends also on long-term effort. A performance fee rewards a mainstream fund manager essentially for good investment decisions assessed against current valuations (what to invest in and the timing of decisions), and, unlike the performance of an illiquid venture capital or private equity fund, can be measured on an ongoing, accounting basis using the daily NAV of the fund calculated against the benchmark.

In other types of investment fund, performance fees are calculated by reference to the value of the fund from time to time. This means the fund can pay out performance fees when the fund value is high, but the fund value can then fall to a lower level at which point the investor sells having suffered the performance fee. This is never the case in private equity and venture capital, where carried interest is only payable where the cash returns paid to investors exceed the benchmark amount.

A carried interest is very different from a performance fee both in its inherent nature (as an interest in the fund alongside investors) and in its underlying economics.

The fund manager will usually be further incentivised to avoid poor performance through a co-investment obligation. This has arisen from investors' insistence that fund managers invest as an investor in their funds themselves, so that the manager stands to lose its own capital if the fund delivers negative returns over its life (see the Appendix for more detail on how these mechanisms typically work), thus sharing in downside risk, as well as the upside.

***The market seems unlikely to abandon carried interest in order to accommodate DC schemes***

In order for DC scheme capital to invest in our industry under the current proposals, venture capital and private equity fund managers would have to design an entirely new approach to incentives and reward. This would be difficult to justify because, for the reasons explained above and in the Appendix, the current structures meet investors' objectives with regard to alignment and achieving long-term outperformance.

The venture capital and private equity industry is global and carried interest arrangements across the industry typically follow the principles set out above and in the Appendix. Carried interest is a long-established arrangement in this industry, which deliberately protects investors' interests. These arrangements are heavily negotiated between managers and professional investors, with the

[11] In a "deal-by-deal" model, which is more common in North American funds, carried interest can be paid after each portfolio company exit. However, even in this model, escrow accounts and clawback mechanisms exist to ensure that initial overpayments of carried interest following successful exits do not distort the agreed profit share proportion between manager and investors, looking at the whole fund's performance during its entire lifetime, in the event that less profitable later exits would otherwise do just that.

respective legal advisors. Requiring wholesale changes to structures that have operated successfully for investors over many years, including during periods of financial market stress, and are recognised by regulators and tax authorities, would be difficult to justify and probably impossible to achieve.

***DWP should therefore consider allowing schemes to exclude carried interest from the charge cap***

We believe that the best solution would be to exclude genuine carried interest arrangements from the charge cap, as well as any performance fees for any type of fund where their payment reflects net returns to investors. In addition, DC pension schemes could find it easier to invest in funds-of-funds targeting illiquid assets.

In parallel, DWP should also explore structures and mechanisms that would allow and encourage DC schemes to focus on the total net return, as well as enabling them to monitor ongoing fees.

***Managing venture capital and private equity investments also entails higher costs***

The typically higher management fees (usually 1.5% - 2.5%) needed for the costs of running a fund (for reasons described below) already work against the inclusion of venture capital and private equity investments in a DC scheme's portfolio. As explained above and in the Appendix, capital drawn down to pay these fees often needs to be returned, alongside a preferred return, before the carried interest is paid.

**Q8. What links have you found between cost and performance?**

The costs are higher in venture capital and private equity for reasons summarised below, however investors have continued to benefit from high performance, net of fees, as summarised in the answer to question 5 above.

The process for making and managing investments in private equity and venture capital is intensive and requires significant resources and expertise. Executing an investment decision usually takes a fund manager many months. It invariably involves:

- extensive origination work to generate appropriate deal flow, from which a small percentage of opportunities (typically only 1-2%) are selected and proceed to becoming investments;
- evaluating risks and opportunities, including ESG factors;
- analysing historic financial data as well as formulating detailed projections;
- developing three to five-year business plans;
- carrying out extensive financial, legal and commercial due diligence;
- leading detailed and often protracted negotiations of transaction terms;
- arranging debt finance facilities;
- structuring the investment appropriately (taking into account investors' circumstances); and
- a range of other activities (such as environmental, IT, intellectual property, pension, insurance and other due diligence).

This is incomparably more involved and expensive than conducting research (albeit skilled and specialist) and ordering the execution of a trade by a broker and requires sustained activity.

Both venture capital and private equity funds make investment decisions with the express intention of gaining substantial influence or control over private companies. This is because our industry's investment proposition involves fund managers using that influence or control in conjunction with their own expertise and networks to grow and thereby increase the value of the private companies, post-acquisition.

A portfolio company's period of venture capital or private equity ownership typically involves the company's investors:

- making arrangements for operational, governance and other issues uncovered during the due diligence process to be resolved;
- the development of the company's strategic objectives;
- refining and implementing a multi-year business plan; investing in capital expenditure;
- identifying and filling gaps in board expertise;
- supporting ESG initiatives and deploying ESG experts where required;
- renegotiating existing finance arrangements and agreeing new ones; and
- many other activities.

This continues throughout the period of ownership, which concludes with a further corporate M&A process to execute the fund's exit from the investment. All this activity is usually overseen by and one or more specialist executives (and often a highly experienced non-executive chairperson) that the fund manager will appoint to the board of the company as a representative of the fund and in many cases supported by a portfolio management team.

In respect of ESG initiatives, the active (and therefore more cost intensive) approach of venture capital and private equity fund managers allows firms to ensure that responsible investment practices, sound governance and sustainability considerations are properly taken into account, and many venture capital and private equity firms actively improve ESG performance and the governance of the companies they invest in. This is a feature of the venture capital and private equity model that should be attractive for pension funds seeking to focus on more responsible approaches to investment.

The level of hands-on ongoing activity inherent in venture capital and private equity fund managers' management of their investments is therefore much greater than that required of many other types fund manager.

**Q9. How much notice should be given for any reduction in the cap?**

A reduction in the cap would further reduce the opportunities for DC pension schemes to access venture capital and private equity funds. The rate of investment is already low, and we are not in favour of a further reduction, even if carried interest is excluded from the cap.

## *Chapter 5: Standardised cost disclosure templates*

**Q14. Is legislative intervention required to support the uptake of the CTI templates?**

For many years, both in the UK and globally, there have been industry-led efforts to (i) improve understanding about the nature of fees and charges in venture capital and private equity and (ii) enhance and standardise disclosures provided to investors. This has led to the proliferation of several templates and initiatives that are relevant to the venture capital and private equity industry including those established by:

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- The Cost Transparency Initiative ("CTI"), the successor body to the FCA's Institutional Disclosure Working Group.
- The Institutional Limited Partners Association ("ILPA"). ILPA is a global organisation with over 500 member institutions representing more than $2 trillion USD of private equity assets under management. ILPA published a fee reporting template in 2016[12].
- Invest Europe, the pan-European association for private capital. Invest Europe has for many years produced investor reporting guidelines which also cover fees and expenses[13]. The BVCA refers UK firms to these guidelines as they cover expectations of UK and pan-European funds.
- Bespoke reporting requirements from institutional investors.

The BVCA is a CTI board member and was involved in the FCA disclosure working group. We led the development of a voluntary private equity template and produced guidance[14] that provided clear information on the structure of private equity funds and the costs entailed.

Over the past year, the private equity template has been tested and expanded so it can be used be used for closed-ended real estate and debt funds. The revised private markets template has now been launched. The BVCA also mapped the CTI template to the ILPA template as our position is that firms should be able to continue to use this as it has been widely adopted. This is in excel form and the link to it is in the private markets FAQs section on the CTI website[15].

Venture capital and private equity managers provide information on costs in the format requested by investors. UK pensions funds represent less that 5% of all fundraising in the UK (as highlighted above) so the uptake of the CTI template has been limited to those investors asking for it, general LGPS investors. The information provided in the ILPA template and required by the Invest Europe Investor Reporting Guidelines, is consistent with the CTI template.

The BVCA is of the view that in light of these efforts, legislative intervention is not required to mandate the use of the CTI templates specifically, as the venture capital and private equity industry does report regularly on fees and costs and to the same standard as the CTI templates, albeit in different formats.

**Q15. How easy is it to request cost information from asset managers?**

As this is a long-term asset class, venture capital and private equity managers often have a close and long-standing relationship with their investors. The constitutional arrangements of funds are heavily negotiated with legal advice sought by both the manager and investor. The resulting agreements are detailed and set out the need for regular reporting. In addition to this, investors will receive tailored reporting on request to meet their specific needs (for example if they themselves are regulated or supervised.

**Q17. Should DB schemes be required to adhere to the same standards?**

The reporting provided by venture capital and private equity firms under the different frameworks above is predominantly to DB schemes in the UK.

[12] https://ilpa.org/reporting-template/
[13] https://www.investeurope.eu/industry-standards/professional-standards/investor-reporting/
[14] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2020/CTI-Private-Equity-Markets-Glossary-of-Terms-Jun-2020.pdf
[15] https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative

We would be happy to discuss the contents of this letter with you; please contact Gurpreet Manku (gmanku@bvca.co.uk).

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee

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**APPENDIX**

This Appendix includes an illustrative example to explain how the economics of venture capital and private equity funds typically work to align the long-term interests of managers with the success of investors' investments.

**How a carried interest arrangement typically operates over the life of a fund**

This is a typical example only and there will be variations across the private equity industry or across jurisdictions, depending upon local conditions and market circumstances.

- *Start of fund's life:*
    - A group of executives set up a fund manager and raise a fund from professional investors to pursue a particular investment strategy. This entails detailed negotiations with those investors regarding many aspects of how the fund will be managed.
    - The investors do not actually make cash contributions to the fund at this point, rather they make a commitment to provide capital on request (a "draw down" request) from the manager so the fund can make investments into portfolio companies as and when the manager has identified appropriate opportunities.
    - The fund manager agrees with its investors, in a legal contract, arrangements related to the: management fee (also known as a priority profit share (PPS) based on its legal structure), carried interest and its co-investment requirement (typically 2-5% of total funds raised).
    - Executives are participants in the carried interest and co-investment arrangements. This is the fund manager's core incentive/alignment package and is variable from the outset as it is entirely dependent on the future (and unpredictable) returns that the fund achieves.
    - The carried interest entitlement is created at this time. Carried interest may be paid at a future date, but only once investors have received their capital back plus an agreed preferred return.
    - The fund starts to make investments.
- *Years 1 to 5:*
    - This is known as the "investment period", during which the fund manager draws down on the investors' capital commitments to make investments in portfolio companies.
    - Capital is also drawn down to pay the management fee/PPS and other fund-related costs. The management fee/PPS typically between 1.5% and 2.5% of the fund's committed capital and is paid to the fund manager during the investment period to cover ongoing costs such as salaries, office rents, travel expenses, etc.
- *Years 6 to 7:*

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- The investment period has ended and the fund starts to realise its investments (e.g. sell portfolio companies to trade buyers, list them on the stock market, etc.).
- The cash proceeds from exits begin to be distributed to investors.
- At this stage, the fund manager is not entitled to any share of these cash distributions because investors have not yet received back the value of their drawn down capital for all investments, management fee/PPS and other costs plus the agreed preferred return (typically 8% p.a.).

- *Years 8 to 9:*
    - The fund continues to realise its investments.
    - Investors have now received sufficient cash distributions to cover their drawn capital for all investments, management fee/PPS and other costs plus the agreed preferred return.
    - At this point, the fund manager becomes entitled to its percentage profit share (carried interest) of all future proceeds from realisations in line with the agreement made with investors at the start of the fund's life.
    - However, even then, the manager's carried interest entitlement will only be released to the fund manager once investors have received further cash distributions sufficient to cover any undrawn capital commitments which the manager could still draw down, and so the carried interest distributions will be retained in an escrow account until this point is reached.

- *Years 9 to 10:*
    - The fund continues to realise its investments in portfolio companies.
    - Investors have now received sufficient cash distributions to cover their drawn down capital plus undrawn commitments (i.e. the total amount that they originally committed to the fund) and the agreed preferred return.
    - The fund manager and its executives share in proceeds from realisations.
    - The fund is wound down once all its investments have been sold, at which point any remaining proceeds held in escrow would be released to the carried interest participants.

**How carried interest arrangements both protect investors and incentivise fund managers**

The carried interest arrangements include a number of protections for investors that have become market-norms following negotiations between fund managers and investors over the years. These protections reflect investors' need to keep venture capital and private equity fund managers incentivised to work to help increase the value of portfolio companies over the long term. Carried interest is treated as remuneration under the Alternative Investment Fund Managers Directive. It is recognised as meeting the remuneration regulatory requirements as explained below.

- *Deferral arrangements*

  - As demonstrated in the example above, carried interest arrangements have an in-built deferral mechanism. Although these arrangements are agreed at the outset of the fund, cash is typically only paid to the fund manager once investors have received their drawn down capital back, plus an agreed preferred return. The period between the agreement of the carried interest structure and cash being paid out to the fund manager will typically be several years.

  - Cash will generally only start paying out under a carried interest arrangement towards the end of a fund's life, rather than at regular intervals throughout the life of the fund. In addition, there are agreed mechanisms (i.e. escrow accounts and clawback) to ensure that if carried interest based arrangements do become due early in the life of a fund (say due to a number of very successful realisations early in the fund's life) the fund manager will not have received any more than the agreed carried interest percentage on the profits of the fund by the end of the life of the fund.

  - It is impossible to determine the future value of carried interest at the outset of the fund. Even when investments are made, their value in the future is impossible to predict. This reflects the fact that if a fund portfolio performs poorly, no carried interest will be paid.

- *Retention*

  - Carried interest arrangements have an inherent retention period as it is generally paid out only when the investors have received both their capital back plus the agreed return which is typically towards the end of a fund's life. This will be several years later (sometimes 9 to 10 years after it was first awarded as shown above).

  - This timeframe ensures longer-term risk alignment with investors in the fund. These arrangements may also have additional in-built protection mechanisms to ensure that investors can claw back any carried interest overpaid for any reason.

- *Malus/ex-post incorporation of risk for variable remuneration*

  - The level of carried interest payments will adjust automatically to the actual returns investors have received over the life of the fund.

  - This is an ex-post risk adjustment and is performance-related.

  - As noted above, there are also escrow and clawback mechanisms to recover any carried interest that may have been overpaid.

  - If the fund does not perform and the required level of returns is not generated for investors, carried interest is not paid out.

**Co-investment aligns managers' and investors' interests over the long-term by ensuring managers' share in any downside**

- Co-investment by executives may be negotiated between investors and the manager to promote alignment of investor interests and to ensure that the investment team has "skin-in-the-game" alongside investors.

- In other words, they put at risk the loss of their own money through their stake.
- There is no common method by which the co-investment is funded. It will depend on the particular circumstances of the prospective participants and the level of the commitment.