Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

4 June 2015

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

Response to the EBA Consultation Paper "Draft Guidelines on sound remuneration policies under Article 74(3) and 75(2) of Directive 2013/36/EU and disclosures under Article 450 of Regulation (EU) No 575/2013"

Question 4: *Are the guidelines regarding remuneration policies and group context appropriate and sufficiently clear?*

Question 6: *Are the guidelines on the identification of staff appropriate and sufficiently clear?*

The private equity industry is responding to the consultation paper given the potential for the CRD IV[1] / CRR[2] regime ("the CRD framework") and as a consequence the EBA Guidelines, to apply to certain activities. Some firms within the private equity industry, that are primarily carrying out private equity activities that are outside the scope of the CRD framework, will also have subsidiaries or affiliates that carry out additional activities and are regulated as CRD IV investment firms. Other firms *could* be impacted by the CRD framework if they are owned by a bank or another institution covered by the CRD framework.

Banking groups owning private equity firms

In those cases where a private equity manager is a subsidiary of a CRD IV credit institution and also falls in the scope of consolidation, members of its staff *could* potentially be subject to the relevant remuneration requirements. However, this would depend on the extent to which their professional activities have a material impact on the risk profile of the CRD institution as a whole. This is an assessment that would need to be made on a case-by-case basis, taking into account the specific features of the institution and the staff members in question.

---

[1] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms

[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms

Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Where there are staff who perform multiple roles across both the CRD regulated entity and a non-CRD regulated entity it should be clear that CRD remuneration requirements only apply to those of their responsibilities that meet the materiality test mentioned in the preceding paragraph.

Private equity managers owning a small CRD firm

There are also instances where private equity managers regulated under AIFMD own a smaller investment manager structured as a CRD IV investment firm.

In these cases the CRD remuneration rules are not applicable to the staff of the non-CRD IV private equity entity (or entities).

First, the non-CRD private equity owner and its other, non-CRD subsidiary/affiliated entities, will not meet the test to apply CRD IV remuneration requirements at a group level.

Second, given the private equity business model, it is very unlikely that the private equity manager is relevant in terms of assessing the risk profile of the CRD-regulated subsidiary institution. CRD IV requirements should only be applied at a group level where group staff have a material impact on the risk profile *of the CRD IV subsidiary*.

Third, in this case the private equity entity will anyway be complying with the dedicated sectoral legislation (AIFMD), its remuneration provisions and ESMA's Guidelines. They set out a regime that is equivalent to the goals and objectives of CRD, though tailored to the specific features of that industry. Furthermore paragraph 32 of ESMA's Guidelines underlines that they apply *"in any case to any AIFM"*, regardless of its relationship to other entities in a group. The final version of the EBA Guidelines should recognise this.

Fourth, it would be inconsistent with the overall CRD framework to apply requirements relating to remuneration to a wider scope of entities than the national competent authorities would deem appropriate for the sake of other prudential requirements.

Scope of Consolidation

We note that the draft Guidelines provide a general reference to the "consolidating institution" by way of a cross-reference to Article 18 of CRR, as the institution responsible for prudential consolidation or sub-consolidation.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

We note also that the wording of Article 92 of CRD IV regarding consolidation is the same as Annex V, Section 11 of Directive 2006/48/EC, point 23, which also stated that the remuneration principles were to apply "*at group, parent company and subsidiary levels, including those established in offshore financial centres*". However, the 2010 CEBS Guidelines provided more clarity and legal certainty by recalling that the scope of consolidated supervision is the one set out in the CRD framework.
The consolidated supervision regime under the CRD framework excludes certain entities from the scope of consolidation, reflecting the EU co-legislators' recognition that there could be undesirable consequences if the consolidation rules were applied in such a way that it captured undertakings for which consolidation would be inappropriate or misleading. In Article 19 of CRR, it is made clear that competent authorities should exclude an entity if "*in the opinion of the competent authorities responsible for exercising supervision on a consolidated basis, the consolidation of the financial situation of the undertaking concerned would be inappropriate or misleading as far as the objectives of the supervision of credit institutions are concerned*".[3]

With respect to a group of entities that encompasses both CRD and non-CRD entities, as described above, we believe the relevant test for applying CRD IV at a group level should be: (i) where the CRD firm is a subsidiary of a larger non-CRD group, whether group staff have a material impact on the CRD subsidiary's risk profile; and (ii) where there is a non-CRD subsidiary of a larger CRD group, whether the non-CRD subsidiary staff have a material impact on the risk profile of the wider CRD group. This approach reflects a proportionate implementation of the requirements at group wide level.

It is also important in our view to maintain in the final version of the Guidelines the statement made by the EBA in its consultation paper (paragraph 63) according to which "*where specific CRD requirements conflict with the sectorial requirements (e.g. under the AIFMD or UCITS Directive), the remuneration policy should set out for the concerned identified staff which requirements should apply within the entity on an individual basis, taking into account the specific sectoral legislation*."

Identification process for staff

The proposal in paragraph 93 to limit the ability of national competent authorities to approve exclusions of staff identified under Article 4(1)(b) of the RTS could impose material administrative burden on national competent authorities. No justification is given for this proposal. The RTS already obliges

[3] Cf. Article 19 CRR.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

firms to consider whether an individual has material impact on the risk profile of a material business unit. Where the role of an individual does not change from year to year, requiring a firm and their national competent authority to repeat the previous year's exercise in respect of the same individual makes little sense.

Effect on existing risk alignment model

We are also concerned that whilst the CRD framework is designed around the pay structures of banks and investment banks, the effect of the proposed changes on CRD IV regulated entities would limit the ability of any private equity firms who potentially fall within the CRD framework to use the industry-wide carried interest based interest and risk alignment model for their staff who are impacted. This is a key part of the model by which private equity managers around the world align the interests of private equity fund manager executives with the interests of their fund investors.

The current private equity risk sharing model is expected and, indeed, required by investors, as illustrated by the Institutional Limited Partners Association (ILPA) Private Equity Principles that state "*Alignment of interest between LPs and GPs is best achieved when GPs' wealth creation is primarily derived from carried interest and returns generated from a substantial equity commitment to the fund, and when GPs receive a percentage of profits after LP return requirements are met*."

The objective of the CRD framework for pay regulation is effective risk management. The CRD framework primarily addresses the remuneration structures of credit institutions and investment banks. Those firms have incentive structures which 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, rather than cash returns.

The CRD framework reduces the incentives of bank staff to increase the risk of failure of a bank through limiting variable remuneration, requiring a minimum amount of variable remuneration to be paid in shares in the institution (thus aligning interests) and imposing clawback and retention.

The regulatory risks in an asset management context are inherently different from those which arise in the banking and investment banking sectors, so the solution to manage remuneration risk must be different. This is recognised in AIFMD, whose remuneration provisions are focused on aligning the interests of fund managers with fund investors.

Moreover, incentive structures used by private equity managers do not share the same features as those used by banks.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Many private equity firms employ incentive structures, in particular carried interest and/or co-investment based schemes, which provide potentially the most significant element of incentive and align the interests of staff with those of investors over the long term.

Where there is a CRD IV regulated investment firm, it would be proportionate for the governing body of such a firm to conclude that the objectives underlying the provisions of the CRD framework summarised above are met by such incentive structures and that certain remuneration principles on deferral, share-based payment and performance adjustment are duplicative of those set out in AIMFD and can be neutralised in relation to that firm. The overarching objective of effective risk management will have been met.

Carried interest and co-investment based arrangements are investment arrangements which feature inherent long-term deferral and risk adjustment characteristics, as well as distribution based only on realised (not merely accounting) profits. There is therefore an obvious and strong policy argument that carried interest and co-investment based schemes satisfy the policy objectives of the CRD remuneration principles. As highlighted above, this model has been both agreed with, and is expected by, private equity fund investors (who are professional investors). We elaborate on these arrangements in Appendices A and B.

Any attempt to apply the CRD remuneration provisions to private equity managers that are not themselves subject to CRD IV would undermine a proven model, endorsed by investors and by sector-specific EU law. As AIFMD and its relevant Guidelines have recognised, this is a legitimate model that achieves an alignment of interests and avoids excessive risk-taking in the private equity industry. This is because distributions, both to the general partner/manager and then to the executives in turn, are typically only paid once investors have received their principal and an agreed return, and then only out of realised cash profits. There is no better, more considered or aligned remuneration structure for the private equity industry.

***Question 5**: In particular institutions that used 'neutralisations' under the CEBS guidelines for the whole institution or identified staff receiving only a low amount of variable remuneration are asked to provide an estimate of the implementation costs in absolute and relative terms and to point to impediments resulting from their nature, including their legal form, if they were required to apply, for the variable remuneration of identified staff: a) deferral arrangements, b) the pay out in instruments and, c) malus (with respect to the deferred variable remuneration). In addition those institutions are welcome to explain the anticipated changes to the remuneration policy, which will need to be made to comply with all requirements. Wherever possible* *the estimated impact and costs should be quantified, supported by a short explanation of the methodology applied for their estimation and provided separately for the three listed aspects.*

I. Concerns raised by the EBA suggested approach on proportionality

In our view, the EBA suggested approach raises several questions, from a methodological as well as from a legal perspective.

1) On the methodology

We welcome the work done by the EBA in order to improve the 2010 CEBS Guidelines, and the explanations provided by the EBA in its consultation paper. However, we are concerned that the revised approach to the application of the proportionality principle as proposed by the EBA has not been appropriately assessed and analysed, nor backed by strong legal arguments.

The industry notes that the legal case for a change to the approach to the application of the principle of proportionality suggested by the EBA is based only on a **preliminary legal analysis** of the remuneration principles set out in Articles 92 to 94 of CRD IV.

In fact, the consultation paper provides only very limited and circumstantial or policy-oriented arguments, but not sound, legal arguments, to explain why such a change in interpretation is justified and necessary.

We note also that the exchange of letters between the EBA and the Commission[4] does not include any further detailed legal analysis taking into account all relevant elements. It merely restates the content of Article 92 of CRD IV and draws a conclusion without examining either the recitals of CRD IV or the preparatory legislative work.

Since this is a very significant change which will have serious implications for certain entities in the scope of the CRD framework, we believe that a complete and extensive legal analysis (beyond the preliminary analysis) is necessary before undertaking such a significant change to the content of the Guidelines on remuneration policies. This is all the more necessary given that the wording of the proportionality principle in the remuneration provisions has not changed since 2010 (cf. *infra*).

[4] See Letter of EBA to the European Commission of 08 January 2015 ; Letter of the European Commission to EBA of 23 February 2015 (Ref. Ares(2015)762549), published by the EBA.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

The industry has concerns regarding other elements mentioned in the consultation paper and the basis on which the EBA concludes that the proportionality principle and the neutralisation approach should be revisited. For instance, the EBA seems to rely in part on the European Parliament Resolution of 3 July 2013 on reforming the structure of the EU banking sector to interpret the text of CRD IV. Although the Resolution was adopted after the political compromise on CRD IV, it does not have legally binding force or interpretative value regarding the CRD framework and cannot be used as legal grounds for any change of approach.

The European private equity industry encourages the EBA to undertake a full legal analysis of the CRD IV text, taking into account the elements provided in this response.

2) On the substance

An objective analysis of the relevant provisions and of the text of CRD IV shows clearly that the EU co-legislator intended for some of the remuneration principles not to apply to certain institutions.

The nature of the provisions on remuneration. We would like to first highlight that the provisions at stake (Articles 92-94 CRD IV) are found in **a directive**. As such, the directive is a legislative act that sets out a goal that all EU countries must achieve. However, it is up to the individual Member States to decide how to do so, and to transpose the EU text into national law. This implies a measure of discretion as to the means used to reach the goals and objectives defined in the EU text.

CRD and CRR were negotiated and adopted at the same time and the co-legislators did not choose to remove this discretion by moving the remuneration provisions to CRR (which, as a Regulation, has a direct effect and does not require transposition). On the contrary, they decided to keep the *status quo*.

Second, the provisions on remuneration do not establish very specific requirements. To the contrary, they provide a list of **principles** (see Article 92 and Article 94 CRD IV). This means that, as a starting point, CRD IV does not define strict, detailed obligations (which may or may not be tempered by certain exemptions) but it rather provides a list of principles, the relevance of which must be assessed for each institution, on the basis of the proportionality principle.

In this context, it should be noted that the Directive's remuneration provisions allow for a margin of interpretation for national legislators. The Commission has previously acknowledged that the provisions of a Directive could even entail "*a*

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

very large margin of interpretation", [5] and it has also recognised that consequently, the approaches taken by different Member States to transpose the Directive differed considerably. This same margin of interpretation can be seen in the wording of Articles 92 and 94 CRD IV: the obligation rests first and foremost on the competent authorities, which shall ensure that institutions **comply with the principles** in a manner and to the extent appropriate. It is sufficient that the remuneration policies should "*accord with the general scheme*" of the principles as structured by the Community legislation, where these principles are proportionate.[6]

Out of the seven main principles listed under Article 92, none use "shall" to specify the obligation, and only four of the principles[7] listed under Article 94 imply a more limited margin of interpretation. All of these remuneration provisions are drafted in a way that implies an individual assessment for each institution is required. If the EU co-legislators had meant to remove this margin of interpretation, they would have:

- removed Recital 66;
- modified the wording of the current high-level principles, so as to turn them into clear and specifically defined requirements; and
- included these provisions in the Regulation.

In contrast, the provisions on the remuneration committee (Article 95 CRD IV) provide an illustration of a specific requirement, with a clear and strictly defined scope. Here, the legislative text does not foresee the possibility to apply the requirement in a manner and to the extent that is appropriate. For this provision, rather than permitting a degree of discretion based on the principle of proportionality, the EU co-legislators decided explicitly that this was a requirement that would apply to certain institutions and not to others. Institutions that are significant in terms of their size must apply the remuneration committee requirement, with no potential for proportionality-based calibration.

The absence of any relevant change to the text from CRD III to CRD IV. It cannot be argued that there has been a change to the wording at Level 1 from CRD III to CRD IV, which would justify a change to the legal interpretation of proportionality. This is an important factor to take into account when assessing

[5] See for instance Report on the Implementation of Directive 90/314/EEC on Package Travel and Holiday Tours in the Domestic Legislation of EC Member States, SEC (1999) 1800 final, in which the Commission did not rely on a general statement, but analysed each provision and reached the conclusion that there was significant margin for national legislators in transposing the Directive.

[6] Judgment of the Court of 24 February 2000 in Case C-434/97.

[7] See sub-paragraphs (d), (g), (k) and (l) of Article 94 of CRD IV.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

the meaning of the proportionality principle. The current debate implies that guidelines adopted in 2010 by CEBS on which the European industry and competent authorities have relied were unlawful and that the Commission did not identify this until specifically asked. This risks undermining the credibility of the guidelines process.

If the EU co-legislator had intended to implement any change regarding the application of the proportionality principle in relation to remuneration, one would have expected it to make an express and explicit change in the actual provisions of the Directive. The fact that there was no such change therefore acts as a clear confirmation that the co-legislators were content with the approach taken by CEBS and with the flexibility to neutralise certain principles found in the remuneration provisions being available to competent authorities and regulated institutions.

In that respect, it must be underlined that the CEBS was extensively involved and consulted throughout the preparation of the CRD IV proposal, and their views contributed to the preparation of the impact assessment and the CRD proposal.[8] At the time, the CEBS Guidelines had already been finalised, published and put into practice, and the EU co-legislators did not identify any issue with these Guidelines and the interpretation of proportionality.

The meaning of the remuneration provisions and the proportionality principle. The wording of Article 92 CRD IV[9] is clear: institutions are to "*comply with the following principles* ***in a manner and to the extent*** *that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities*". The use of "to the extent" means that certain remuneration principles may not apply fully or at all to some institutions, and in accordance with the general principle of proportionality established in the EU Treaties, that the content of Union action must not exceed what is necessary to achieve the objectives pursued.[10] The subsequent list of factors specifies those instances in which the principles may not apply fully or at all.

The EBA's suggested interpretation, which is based on the position taken by the Commission in its letter of 23 February 2015, is clearly in contradiction with the very wording of the Directive. First, the Commission letter states that "*Articles 92 and 94 apply to all <u>institutions</u>*". Although both articles mention "institutions", recital 66 makes abundantly clear that the legislator did not mean to apply all remuneration principles to all institutions. The CEBS thus did

---

[8] Cf. Commission Impact Assessment, 20 July 2011, SEC(2011) 949 final.

[9] The same reasoning applies to Article 94 CRD IV, which includes a cross-reference to Art. 92 CRD IV.

[10] Cf. Article 5(4) of the Treaty on European Union.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

not "decide that certain rules adopted by the co-legislators shall not apply"; but it spelled out in its Guidelines the idea already contained in CRD IV that, **as a matter of principle**, not all remuneration principles apply to all institutions.

In addition, we note that the Commission letter does not take into account the fundamental idea underlying the proportionality principle, namely the fact that it must not exceed what is necessary.

The effect of the proportionality principle is that not all institutions have to give substance to the remuneration principles in the same way and to the same extent. Proportionality operates both ways: some institutions will need to apply more sophisticated policies or practices in complying with the remuneration principles; other institutions can do so in a simpler way.

In its consultation paper, the EBA states that CRD IV does not provide for any explicit provision that allows for the waiving of certain remuneration principles. However, Recital 66 of CRD IV explains that *"the provisions of this Directive on remuneration should reflect differences between different types of institutions in a proportionate manner, taking into account their size, internal organisation and the nature, scope and complexity of their activities. In particular it would not be proportionate to **require certain types of investment firms to comply with all** of those principles."* This Recital clarifies that in some cases certain remuneration principles do not have to be complied with **at all**, since applying these principles would not be proportionate in view of the size, internal organisation and the nature, scope and complexity of activities.

The wording of Recital 66 is reflected in the drafting of the substantive provision in Article 92, cited above. Article 94 provides that the principles relating to variable remuneration must be implemented *"…under the same conditions as those set out in Article 92(2)"*.

The objectives behind the remuneration provisions and the proportionality principle. The remuneration provisions were designed to address the limitations of the incentive model of banks. However, as mentioned above, the CRD framework also potentially applies to other, very different entities and it was in recognition of the different characteristics of such entities, and the need to ensure that remuneration provisions are implemented appropriately, that the EU co-legislators chose to include provisions on proportionality - a concept with a precedent in an earlier CRD iteration and for which there is a clear interpretation. Requiring other entities, like private equity fund managers that may fall in the scope of the CRD framework, to apply <u>all</u> remuneration provisions in precisely the same manner as all banks would not be in line with the EU co-legislators' intention. CRD IV allows flexibility to adapt the manner and the

Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

extent of the application of the principles, taking into account the size, internal organisation and nature, scope and complexity of institutions' activities.

Neutralisation (on the basis of the proportionality principle) does not constitute a general waiver from the remuneration provisions. The neutralisation envisaged by the CEBS does not amount to a general waiver from the remuneration requirements.

- First, and as recalled by the CEBS Guidelines, "neutralization is never automatically triggered on the basis of these guidelines alone". There is therefore no general waiver.

- Second, the Guidelines do not have the same binding force as Level 1 provisions; the Guidelines cannot restrict the scope of Level 1 provisions, which are otherwise clear.

- Third, the Guidelines apply on a "comply or explain" basis; each institution (and competent authority) has to assess its position with regard to the remuneration requirements, and must be ready to explain why it is not compliant.

The assessment of the application of proportionality and the extent to which a principle is relevant for a given institution, would be assessed on a case-by-case basis. It should rely on an institution's specific characteristics, which among other things may include its importance for a banking group.

In that respect, it must be recalled that private equity fund managers have a completely different risk profile to banks and that the AIFMD sets out the European legislators' response to these risks. This response further expressly recognised the contribution to risk alignment played by carried interest structures and the legitimacy of those structures.

Private equity funds are usually structured as closed-end vehicles with a minimum typical life-span of 10 years, to ensure that the underlying companies in which investments are made have the time and potential to grow and develop further. They are not designed to be traded like a liquid asset, and investors have no ability to redeem their investment during the life of the fund.
The risk of failure of a private equity manager is of a different order to the risk of failure of a bank. The private equity fund manager is not a counterparty to any investment transaction; investments are made by the separately constituted fund, whose investment capital belongs to its fund investors. Where a private equity fund manager becomes insolvent, there would be no impact on the portfolio companies which the fund owns, nor on the wider financial services market. The impact on the fund would be that it would need to appoint a new

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

general partner, i.e. the investors would need to find a replacement manager for the fund. This is a totally different order of magnitude from the risk posed by banks.
Furthermore, the private equity model protects against systemic risk by ensuring that no portfolio company bears any risk as a result of the debt of other portfolio companies in a fund. Private equity funds' investments are diversified both geographically and among industries. Each portfolio company group has its own specific holding company and is managed independently. A portfolio company group backed by a private equity fund is not in any way responsible for or exposed – directly or indirectly – to the borrowings of any other portfolio company of the same fund. Therefore, since private equity activities are diversified and private equity structures are not cross-collateralized (they are silo-ed for each portfolio company), they do not give rise to systemic risks.

Private equity funds do not face the risks of "runs" because their investments are fully backed by equity commitments from their investors, which are predominantly institutional such as pension funds and insurance companies (but also banks), and are structured as closed-end funds to which investors are committed throughout the life of the fund, with no discretionary right of redemption.

The counter-example of remuneration disclosure under the CRD framework. Within the CRD framework, where the EU co-legislators did not intend for neutralisation of remuneration provisions on the basis of proportionality, it is explicitly reflected in the Level 1 text. Thus, regarding disclosure of remuneration information, Article 450 of CRR provides that *"Institutions shall comply with the requirements set out in this Article <u>in a manner that is appropriate</u> to their size, internal organisation and the nature, scope and complexity of their activities and without prejudice to Directive 95/46/EC."*

Here the legislators, crucially did not include the wording "to the extent"; it is only the manner (not the extent) of the obligation, which may benefit from flexibility. All institutions are to comply with these remuneration **<u>requirements</u>**, and must disclose certain remuneration information, although the amount of information to be disclosed may vary from one institution to another.

Interpreting Article 92 CRD IV and the proportionality principle in view of the case law of the Court of Justice. The remuneration provisions in CRD IV are ultimately subject to the interpretation of the European Court of Justice. In that respect, it must be recalled the long-standing principle according to which, "*in interpreting a provision of Community law it is necessary to consider not only*

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

its wording but also the context in which it occurs and the objects of the rules of which it is part".[11]

The starting point for the interpretation of the remuneration provisions ought to be the relevant articles (Article 92 and Article 94 CRD IV, notably). Although the case law confirms that in itself the preamble to a Community act has no binding legal force,[12] it does not mean that it has no interpretative power and should also be considered. The Court of Justice has also clarified that recitals cannot be relied on as grounds i) for derogating from the actual provisions of the act in question or ii) for interpreting those provisions in a manner clearly contrary to their wording.[13]

We do not dispute these precedents. However, we would argue that they are not relevant in the present case. First, the provisions at stake already make clear that the remuneration principles are not meant to apply to all institutions in the same manner or to the same extent. Second, Recital 66 referred to above must not be read as attempting to derogate from a requirement strictly defined under Article 92; and it is not used either as a ground for interpreting Article 92 in a manner clearly contrary to its wording. Rather, it confirms and illustrates the proper interpretation of CRD IV, according to which one end of the spectrum in the proportionate application of the remuneration principles, which can be determined and tested by the supervisory authorities on a case-by-case basis, is that certain institutions should not be subject to certain of the remuneration principles **at all**.

Our interpretation of Article 92 CRD IV is thus corroborated by Recital 66 in the preamble to the Directive. Such an interpretation is fully in line with the rules of interpretation applied by the European Court of Justice.[14] Any other interpretation calling into question the neutralisation approach would not be compatible with the teleological interpretation[15] of the text of CRD IV and would actually deprive institutions from the right to a proportionate application of remuneration rules.

A new interpretation incompatible with the general principles of EU law. Last, the new interpretation suggested by the EBA is not compatible with two general principles of EU law: the principle of legitimate expectations and the principle of legal certainty.

---

[11] Judgment of the Court of 17 November 1983, case C-292/82, Merck, para 12.

[12] Judgment of the Court of 24 November 2005, case C-136/04, para. 32.

[13] Idem.

[14] See Judgment of the Court of 12 December 1996, in Cases C-74/95 and C-129/95, *Criminal proceedings against X*, para 39-40.

[15] See Judgment of the Court of 13 December 2007 in Case C 463/06, para 28.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

The principle of **legitimate expectations**: based on the CEBS Remuneration Guidelines, certain financial institutions have developed "legitimate expectations" regarding the application of proportionality set out in those Guidelines. The concept of "legitimate expectations" is a key principle of EU law. If there were a sudden change to the neutralisation approach, it would be in breach of this principle.

The principle of **legal certainty** requires that legal rules be clear and precise, and it aims to ensure that the situations and legal relationships governed by EU law remain foreseeable.

Institutions are presently required to apply CRD IV; and the relevant guidance which may currently be relied upon is found in the 2010 CEBS Guidelines. These Guidelines acknowledge that neutralisation of certain principles, on a case-by-case basis, may be justified. The change suggested by the EBA would severely disrupt the remuneration practices of many financial institutions and small investment firms, in spite of a long-established practice. This would weaken legal certainty.

Instead of reinterpreting the remuneration provisions of CRD IV, the EBA should preserve the *status quo*. Such a course of action would be all the more appropriate since Article 161 of CRD IV provides that "*by 30 June 2016, the Commission [must], in close cooperation with EBA, submit a report (…), together with a legislative proposal if appropriate, on the provisions on remuneration*". In particular, this report is to assess "*any lacunae arising from the application of the principle of proportionality to those provisions*". If the EBA goes as far as reinterpreting the provisions of CRD IV on the grounds that there are discrepancies in implementation, and in spite of the powers given to the Commission to report on this and to make a legislative proposal, it could potentially exceed its power. Greater convergence through changes to the proportionality approach may only be achieved at Level 1, and are not within the scope of powers of the EBA.

Application of proportionality to the limit on the ratio between variable and fixed remuneration. There is no legal basis for the assertion in paragraph 72 of the EBA's paper that the proportionality principle does not apply to the requirement to set appropriate ratios between fixed and variable remuneration. Article 94(1)(g) is subject to the proportionality principle in the same way as the rest of Article 94.

Outside of the banking sector, there may be good sector-specific reasons for concluding that the application of ratios designed for the banking sector would defeat the underlying objectives of risk management and risk alignment of CRD.

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

If the 100%/200% ratio is applied to investment managers without proportionality, managers are likely to increase fixed pay which will increase their cost base. For private equity managers, this would decrease the alignment between fund managers and investors. Private equity managers have a different pay structure to the banking industry, reflecting the long term nature of private equity investment and the relationship between senior private equity executives and their investors.

The effect on de minimis arrangements. The approach to proportionality could force a number of individuals with low variable remuneration to be caught within the scope of CRD IV. This may lead to the application of rules on variable pay for very small bonuses, which could be impractical, make these roles less attractive and have a disproportionality high administration cost.

II. Private equity remuneration structures and carried interest

If the proportionality principle is implemented as currently proposed, there is a certain risk of negative consequences for those private equity fund managers that fall within the scope of the EBA Guidelines. It is also likely to undermine, substantially, established remuneration arrangements applied in the private equity industry which achieve the objectives that the new Guidelines seek to achieve. In Appendices A and B, we set out illustrative diagrams of private equity fund structures, and a written explanation and description of "carried interest" and "co-investment" which are particular features of our industry. We urge the EBA to consider them in detail before finalising guidelines applicable to firms which use such arrangements.

These arrangements have been developed jointly over many years between private equity fund managers and professional investors and are applied internationally. The carried interest and co-investment based arrangements for incentivising private equity executives are specifically designed to align the interest of investors and executives and anything which undermines these arrangements could in fact threaten a structure which the industry (and indeed regulators) considers already achieves the underlying policy objectives behind remuneration regulation, including those for deferral and performance adjustment. Carried interest based arrangements and the private equity remuneration structures do not contribute to, or reward, excessive risk-taking. On the contrary, they are very effective risk management tools which should not be diluted or undermined.

The application of the proportionality principle is a necessity for the private equity industry when applying the remuneration provisions in the context of carried interest. Carried interest and co-investment based arrangements are investment arrangements which feature inherent long-term deferral and risk

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

adjustment characteristics, as well as distribution based only on realised (not accounting) profits. These arrangements are expected by private equity investors and are endorsed in the Private Equity Principles issued by ILPA. The application of the provisions regarding deferral, payment in units and malus in full would be artificial and most likely unworkable. More importantly, they would not serve the investors' interest.

Private equity managers are typically entitled to a priority profit share or a management fee, which is based upon commitments, contributions and/or acquisition costs as the case may be. It typically serves the purpose of paying costs of the manager (office space, salaries, etc.). The main method of aligning interests and providing a variable long term incentive to executives [and other investment staff] is through the carried interest and co-investment based models. Carried interest is a share in the cash profits of the private equity fund for which the fund manager is typically only eligible once investors have received their drawn down capital (including typically also amounts drawn to pay the priority profit share/ management fee) back plus any agreed preferred return. Investors in private equity funds are professional and often seasoned investors with experience of negotiating, with the support of their professional advisors, the terms of incentive structures and the returns they are seeking.

The typical carried interest based structure, which, as stated above, satisfies the policy objectives of the remuneration provisions of CRD IV, ensures that the fund manager (and subsequently the executives and staff as the case may be) only shares in the net cash returns achieved by the fund as agreed, between the manager and its investors, prior to the start of the fund's life. In this type of structure, also in the cases where sharing of the net returns between investors and the manager may occur during the life of the fund, there are typically measures in place (for example, escrow, interim claw-back and end of life true-ups) designed to protect investors, such that by the end of the life of the fund, the fund manager should only have received its pre-agreed share of the net profits generated.

This type of structure is designed to ensure that managers and subsequently their executives do not benefit from carried interest if investors do not receive their capital and the agreed preferred return.

This structure encourages focus on the performance of the fund(s) and its long term success as returns are only distributed to the general partners/ managers and subsequently to their executives as and when investments are realised and have further generated a total return above an agreed rate across the fund's whole portfolio. Moreover, if the fund loses money, the general partner/manager will similarly lose its money as will executives when co-

Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

investment arrangements are in place. This further aligns the interests of managers executives and investors.

Private equity compensation structures do not have the flaws and associated risks that have been identified in arrangements in other parts of the financial sector, where executive and staff bonuses often fail to take account the long term impact of actions and where equity further vests with immediate effect.

The benefit of this model has been tested and vindicated during the recent financial crisis. For some private equity firms, carried interest schemes did not pay out at all, or paid out significantly less than might have been expected in the past, given the performance of the funds managed. This is exactly the outcome the CRD remuneration provisions are seeking to achieve. Implementing a change now to how the proportionality principle is interpreted would be counter-intuitive as it would require a retrograde change to a structure which already demonstrably works and meets the policy objectives.

It is difficult, if not impossible, to estimate the costs associated with the proposal to remove the possibility to neutralise certain remuneration provisions on the private equity industry and, as can be seen, we believe that this misses the key point. If the proposal were to be implemented it would require such a fundamental change to remuneration policies and procedures in place for those firms impacted that the whole nature of their basis would be called into question. Fund managers and investors would have to re-visit one of the main tenets on which the industry has been based and could well result in a fundamental alteration that would ultimately have the effect of reducing the alignment of interests between investors and fund managers. This would not be welcomed by investors and may even result in some investors being less inclined to invest in the asset class.

III. Conclusion

There should be no change to the interpretation of the application of the proportionality principle. The change suggested by the EBA contradicts the legal interpretation of the proportionality principle and the intention of the EU co-legislators expressed in the CRD IV/CRR framework.

We believe the correct interpretation and application of CRD IV should result in the proportionality principle allowing certain types of institutions (i.e. investment managers whose insolvency would present no systemic risk) to neutralise certain remuneration principles, as part of the spectrum envisaged by the legislator in the application of the remuneration rules. In that respect, the industry welcomes the fact the EBA is convinced of the usefulness of neutralising

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

certain rules and is in favour of a broad application of the proportionality principle.

We consider the correct legal reading of the proportionality principle should enable firms and national competent authorities to effectively calibrate the remuneration principles to the wide ranging types of firms and structures subject to the CRD framework. It should allow (i) the principles to be applied to different categories of institution according to their respective risk profile and remuneration structures and (ii) within that, encourages and requires individual organisations to implement the remuneration principles in a tailored and effective way. We believe this increases the likelihood of firms' remuneration arrangements achieving the intended risk alignment objectives overall. No private equity fund manager has required a state bail-out and no aspect of private equity carried interest structure is based on accounting profit. A credible regulatory system must recognise these fundamental differences.

Many of the investment firms impacted will be significantly smaller in size and complexity than the institutions for which the provisions were designed. In any event, private equity fund managers, as explained above and whether subject to CRD IV or not, already use highly-aligned compensation structures that encourage focus on the long term success of funds managed and prevent excessive risk-taking. As such, they already achieve the underlying policy objectives behind the remuneration provisions.

The private equity industry strongly recommends the EBA to reconsider its approach to the interpretation and application of the proportionality principle. We consider the proportionality principle to be an essential tool for ensuring that firms adopt effective and workable remuneration practices that reflect and are appropriate to their differing risk profiles and governance structures, and we believe the EBA Guidelines should take that into account.

We stand ready to engage with the EBA in order to further explain the view of the industry and provide further information on this subject to assist in ensuring a tailored and proportionate implementation of the CRD IV remuneration provisions.

Question 8: *Are the requirements regarding categories of remuneration appropriate and sufficiently clear?*

Paragraph 120: It is accepted that typical long term incentive plans ("LTIPs") are variable remuneration. Certainty is required as to value for the purpose of complying with the remuneration principles. It seems to us that paragraph 120 unhelpfully uses and confuses the concept of "award". An <u>award</u> (or 'grant') of an LTIP occurs only once, albeit the conditions of the vesting of that award

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

mean that the employee in question may never actually receive the benefit of some or all of that award. It must also be the case that, for the purposes of calculating the ratio between the variable and fixed component of remuneration (and other compliance with the remuneration principles), the LTIP is valued as at the **date of grant** using an acceptable valuation model. Clearly, if an LTIP were structured so that it was contractually granted in tranches, each tranche would need to be valued as at the date it was legally made. That is not, however, a customary way of awarding LTIPs.

Paragraph 121 relies on a concept of carried interest based remuneration either representing (or not) a "pro rata return on the investment made by staff". This is not a concept which brings clarity as used in the EBA Draft Guidelines. The ESMA Guidelines on sound remuneration policies under AIFMD use similar wording but in a more explanatory and relevant way. The EBA Draft Guidelines seem to confuse the concepts of carried interest and co-investment. Carried interest originated remuneration and co-investment are, depending on firm and/or jurisdiction, two different concepts (see our response to Question 5). Private equity firms can operate carried interest based schemes either with or without mandatory (or voluntary) staff co-investment schemes. Whether or not co-investment exists, typical carried interest based schemes deliver on all the pay-out process requirements, and more generally the policy requirement of sound and effective risk management, as explained earlier in this response.

To the extent that carried interest based remuneration is treated as variable remuneration for the purposes of CRD IV the EBA should confirm that carried interest based schemes that meet the requirements as described in ESMA's Guidelines on sound remuneration policies would be treated as satisfying the requirements of the remuneration principles. As such no further steps are required to be taken when amounts are paid out under such schemes. It would not be proportionate and legitimate to require a CRD entity that is part of a bigger asset management group to change such a remuneration structure and apply remuneration rules that may not necessarily fit its business model. Furthermore paragraph 32 of ESMA's Guidelines makes clear that they *"apply in any case to any AIFM".* It states explicitly that *"there should be no exception to the application to any of AIFMs which are subsidiaries of a credit institution of the sector-specific remuneration principles set out in the AIMFD and [ESMA'} Guidelines."*

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

IV. Appendix A

An explanation of carried interest and co-investment arrangements in the private equity industry

The description below is an illustrative example and is not uniform across all firms nor jurisdictions. The Appendix sets out diagrams which illustrate the below.

Investment management fee and salary

- A fund structured as a limited partnership is created through detailed negotiation between investors (also known as "limited partners") and their advisers, on the one hand, and the private equity management group on the other hand. Investors make commitments to invest in the fund, i.e. the amount they originally agree to subscribe to the fund. The amount committed is not paid immediately on a fund's closing but in tranches over the commitment period (typically four to seven years).
- The private equity management group owns the general partner (one of the partners in the fund) and the investment manager, which manages the fund. (In some cases the general partner and investment manager are a single legal entity.) This results in a document which sets out the key terms of the fund.
- Pursuant to the constitutional documents of the fund, the private equity group receives a fixed annual amount for managing the fund. This is often structured as a fee charged by the investment manager to the general partner, who pays the fee out of its priority profit share received from the fund ("PPS"). Any increase in risks in the fund does not increase the amount of management fee, so there is no incentive to increase these risks. Private equity managers must therefore carefully budget to ensure their cost base is covered by the PPS.
- The PPS/management fee is intended to cover the operating costs of the general partner and investment manager, including salaries, as well as, in some cases, pension contributions and life and critical illness insurances plus external fees to investment and other advisors, etc.

Fund profitability

- Crucially, profits are achieved by the fund only on a successful realisation of the fund's investments, which might arise on the sale of the portfolio company or following its initial public offering. Fund 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

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

purposes of transparency but these are not relevant to fund flows.) Typically, proceeds received by a fund are distributed in a timely fashion to investors and are not held within the fund pending a fixed distribution date sometime in the future.

- In some cases, a portfolio company may be refinanced during the period of ownership by the fund. In this case, proceeds will be received by the fund and distributed to investors even though the company remains in the portfolio to be fully realized at a future time. But again, these proceeds are realised in the hands of investors, so reducing what is known as the investors' capital at risk in 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).
- When the fund as a whole becomes profitable, the general partner is allocated PPS from its profits, but its share of proceeds must first go to repay the amounts paid into the fund by investors in earlier years. This ensures that investors receive back all of the money they have actually paid under the terms of the fund.

Carried interest

Carried interest is negotiated by the fund investors and follows quite predictable norms dictated by fund investors. The key features of carried interest arrangements relevant to CRD IV remuneration requirements are as follows:

- The level/terms/design of carried interest receivable by the investment manager from the funds is negotiated between the firm and the investors in those funds. The investors are almost universally institutional (professional) investors, who are highly experienced and well advised. To ensure alignment with their interests, investors will typically require key members of the investment team at the investment management firm to be part of the carried interest base remuneration structure and also expect to see a co-investment obligation from these team members.
- Investors must receive back from the fund in cash an amount equal to their drawn down commitments (the amounts they actually pay in to the fund) plus a preferred return (typically 8-10% p.a.). Only then does the general partner/manager or carried interest vehicle start to participate in profits. After this preferred return has been reached, profits are split in accordance with a pre-determined formula agreed with investors and set out in the fund constitutional documents, typically 80% to investors, 20% to the general partner/manager or the carried interest vehicle. In other words, carried interest operates on a cash to cash (realised profits only) basis. It does not

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

pay out based on accounting valuations. This approach is designed to ensure that the fund manager is incentivised to see all investments as being important to generating returns for investors rather than being tempted to take excessive risks with any single investment.

- It will normally be several years before carry payments are received by the members of the investment team who are incentivized through the carried interest structure. Many funds raised just before the financial crisis in 2009 have only recently come into “carry territory”. There is, therefore, inherent "deferral" in carry schemes.

Co-investment

The typical features of co-investment arrangements relevant to CRD IV remuneration requirements are as follows:

- Co-investment by private equity executives may be negotiated by investors (and often the firm) to promote alignment of investor interests and to ensure that the investment team has "skin-in-the-game" and invests on the same economic terms as the 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 initial commitment.

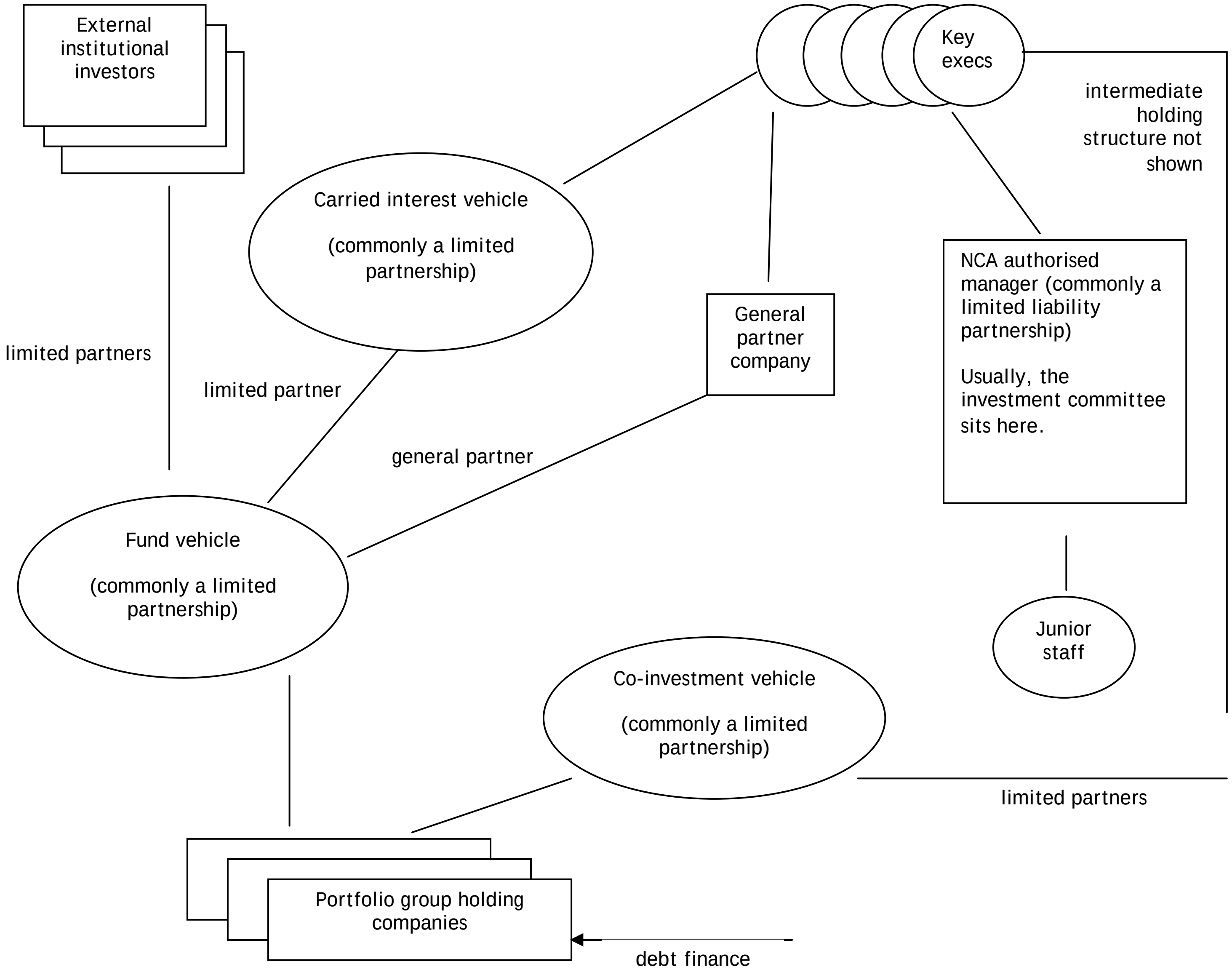
Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Appendix B

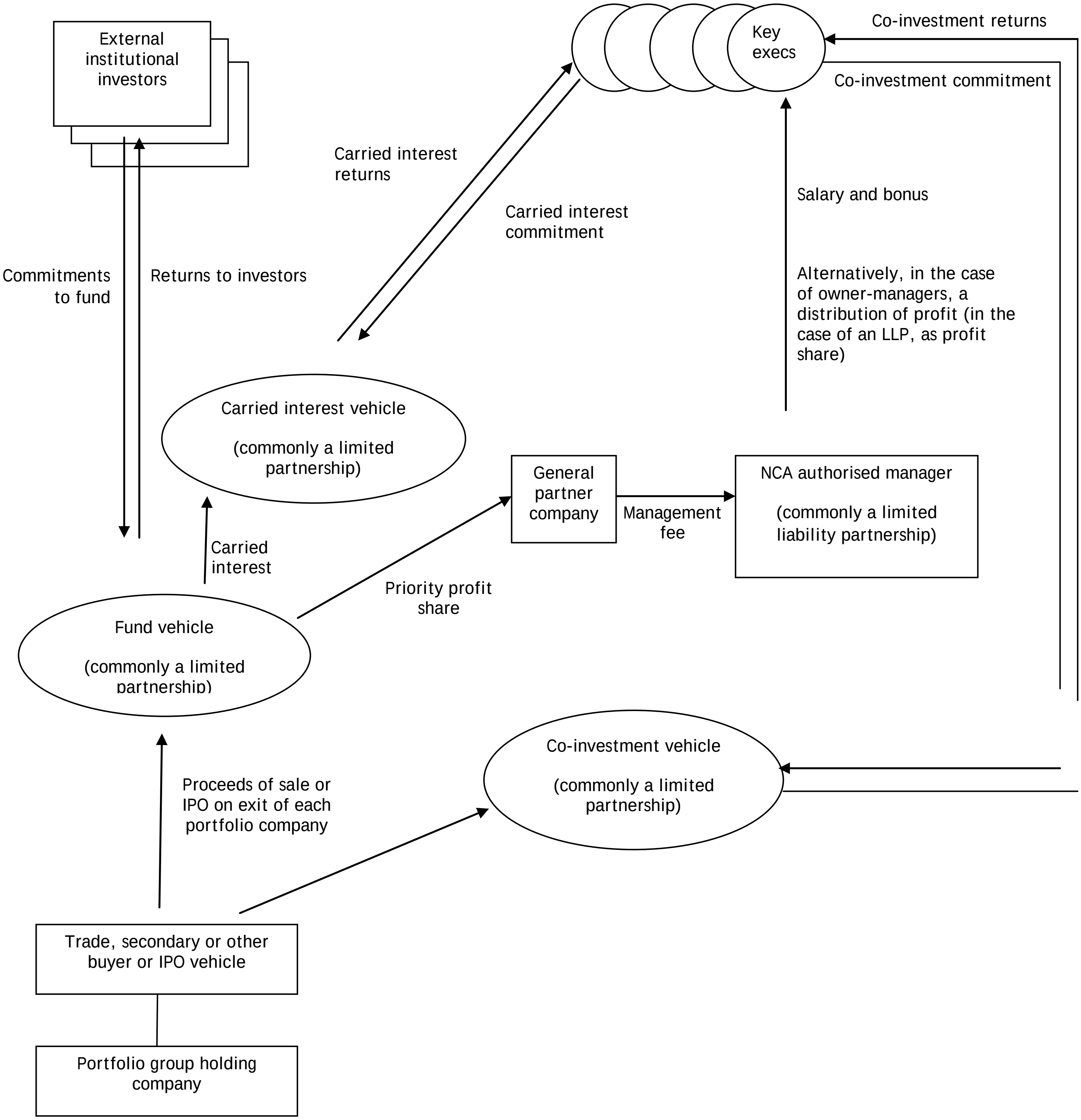
Note: The diagrams below are illustrative only and not all firms operate in the same way.

Figure 1: example legal structure



European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

Figure 2: funds flow diagram (for a single portfolio company sale)



Submission

European Private Equity & Venture Capital Association
Bastion Tower, Place du Champ de Mars 5
B-1050 Brussels, Belgium
T +32 2 715 00 20 F +32 2 725 07 04
info@evca.eu www.evca.eu
CREATING LASTING VALUE

About the PAE

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

About EVCA

The EVCA is the voice of European private equity.

Our membership covers the full range of private equity activity, from early-stage capital to the largest private equity firms, investors such as pension funds, insurance companies, fund-of-funds and family offices and associate members from related professions. We represent 650 member firms and 500 affiliate members.

The EVCA shapes the future direction of the industry, while promoting it to stakeholders such as entrepreneurs, business owners and employee representatives.

We explain private equity to the public and help shape public policy, so that our members can conduct their business effectively.

The EVCA is responsible for the industry's professional standards, demanding accountability, good governance and transparency from our members and spreading best practice through our training courses.

We have the facts when it comes to European private equity, thanks to our trusted and authoritative research and analysis.

The EVCA has 25 dedicated staff working in Brussels to make sure that our industry is heard.