Submission

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

September 27, 2012

To **ESMA**

Re **Response to**

ESMA Consultation Paper: Guidelines on sound remuneration policies under the Alternative Investment Fund Managers Directive (AIFMD), 28 June 2012, ESMA/2012/406

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Introduction

1. We write on behalf of the representative national and supranational European private equity and venture capital ("PE/VC") bodies. Our members cover the whole investment spectrum, including the institutional investors investing in a broad range of PE/VC funds, as well as the PE/VC firms raising such funds, who in turn invest in the full life-cycle of unlisted companies, from high-growth technology start-ups, to the largest global buyout funds turning around and growing mature companies, and thus we speak on behalf of the entire European PE/VC industry, investors as well as managers.

2. We welcome the opportunity to respond to ESMA's consultation concerning its Guidelines on Sound Remuneration Policies under the AIFMD (the "Guidelines"). We stand ready to provide whatever further contribution to this work ESMA might find helpful, including attending meetings and contributing further materials in writing.

3. We set out below answers to ESMA's questions relevant to the PE/VC industry. However, many of our key concerns and comments are of wider application and are not linked to particular questions posed by ESMA. We therefore address more general issues in a narrative format before the responses to individual questions. In this response: (a) references to "CP paragraphs" are to paragraphs of ESMA's consultation paper; (b) references to "DG paragraphs" are to paragraphs of the draft Guidelines in Annex VII to the consultation paper; and (c) technical terms used but not otherwise defined have the meanings attributed to them in ESMA's consultation paper.

4. We welcome ESMA's approach to development of the Guidelines, including due adaptation of the CEBS guidelines on CRD III to reflect the differences between the non-bank asset management sector and the banking sector, and the differences between the CRD and AIFMD. We also welcome ESMA's recognition that not all alternative asset managers are the same, and that the incentive and remuneration models they employ vary. However, the asset management sector is very broad, and we believe further work is required to ensure that the final Guidelines take into account the very different business models that are covered by the AIFMD.

5. We welcome ESMA's recognition that typical PE/VC incentive models feature inherent long-term deferral and risk adjustment characteristics, as well as distributions based only on realised (not accounting) profits to investors. The risk-sharing and incentive structure used in the PE/VC industry is one which has been developed jointly over many years between the fund managers and investors, with the specific aim of aligning interests between the fund manager and its investors. Consequently, we strongly believe that the typical carried interest structure which operates in the PE/VC industry already satisfies many of the AIFMD's policy requirements, including those for deferral and performance adjustment. Neither carry arrangements nor the PE/VC remuneration structures contribute to, or reward, excessive risk-taking.

6. In light of these facts, we request that the final Guidelines include an express recognition that as a matter of general EU law and the specific intent of the EU legislator as set out in Annex II, paragraph 1 of the AIFMD, **the principles set out in Annex II and ESMA's guidelines should be applied in a proportionate manner** and that (as noted in paragraph 20 of the CEBS guidelines on CRD III) **the application of the proportionality principle may lead to neutralization of some requirements if this is reconcilable with the risk profile, risk appetite and strategy of the relevant AIFMs and of the AIFs they manage**.

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7. In other words, we ask that EU regulation, including the Guidelines, continue to recognise that the typical PE/VC carried interest structure is a specific model that ensures ex-ante alignment of interests thanks to the co-investment by the sponsors of the private equity partnerships (often via a carried interest vehicle) and ex-post adjustment, protects investors' interests during the whole life of their investments thanks to the guarantees included in the LP agreements, and is secured by its payment to the carried interest holders only once investors have received their money back, and that for all the reasons above, carried interest is totally different from any payment covered by CRD III provisions on remuneration.

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Key concerns

Carried interest - General

8. We welcome ESMA's recognition that PE/VC carried interest structures meet the remuneration policy objectives of AIFMD, although we have concerns about the specific language of the proposed guidelines, as discussed in more detail below.

9. Carried interest in a PE/VC context is not "remuneration" in any ordinary sense of the word. Carried Interest is a share in the gains realised from an AIF's underlying investments. Carried interest is generally considered to be a key mechanism for aligning the AIFMs' and the investors' interests in a PE/VC AIF and is part of the risk-sharing and incentive package negotiated with the investors.

10. The definition of carried interest in Article 4(1)(d) AIFMD is inconsistent with the PE/VC model, since carried interest does not represent "compensation for the management of the AIF" but is a share in the gains realised from an AIF's underlying investments allocated to the AIFM or related individuals or vehicles ("carried interest vehicles"). The AIFM is compensated for its management activities by way of a separate management fee that provides a regular income to meet operational costs. Carried interest, as opposed to being another management fee, actually represents a share in the returns of the AIF which accrues on the investment (of a highly contingent nature) made by the sponsors of private equity partnerships.

11. Even though carried interest is not "remuneration," as explained above, we agree that it should be taken into consideration in the manner proposed in the draft Guidelines for the satisfaction of the alignment of interest and other criteria as set out in Annex II to the AIFMD. In particular, we welcome ESMA's recognition (in CP paragraphs 191 to 193; DG paragraph 150) that PE/VC carried interest structures align the interests of managers and Identified Staff with those of investors and that such structures can meet key requirements of the AIFMD.

12. As discussed below, however, we believe that greater clarity and flexibility is required in the final Guidelines. We note that competent authorities (who may not be familiar with PE/VC remuneration and incentive models) are likely to rely heavily on the final Guidelines.

The description of carried interest is overly restrictive

13. The Guidelines should not mandate any particular carried interest model so long as the AIFMD's policy objectives are satisfied. We contend that the typical PE/VC carried interest structure (described in paragraph 15 below) satisfies the policy objectives of the AIFMD.

14. In that context, we are concerned that the description of carried interest in DG paragraph 150 and CP paragraph 192 is unduly restrictive in its description of which carried interest structures will be deemed to satisfy principles set out in Annex II of the AIFMD. Other formulations of the carried interest waterfall may be required by, or negotiated with, investors which meet the same policy objectives as the one described by ESMA.

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15. The typical PE/VC carried interest structure, which we, as stated above, believe satisfies the policy objectives of the AIFMD, ensures that the AIFM only shares in the net returns achieved by the AIF at the split agreed between the AIFM and its investors prior to the start of the AIF's life. In this structure, although sharing of the net returns between investors and the AIFM may occur during the life of the AIF, there are typically measures in place (for example, escrow, interim claw-back and end of life true-ups) to protect investors, such that by the end of the life of the AIF, investors will have received back all the money they have paid into the AIF, and the AIFM will only have received its agreed share of the net profits generated.

16. This type of structure ensures that managers and/or Identified Staff do not benefit from carried interest if investors do not receive a full pay back of their contributed monies and any agreed preferred return. Thus, it achieves the same economic effect as the example model described by ESMA and exhibits the same attractive features from a remuneration policy perspective.

Significance of carried interest for other elements of variable remuneration

17. Under the draft Guidelines, the implications if a PE/VC AIFM's incentive arrangements include carried interest are unclear. We believe that a particular AIFM might conclude that, provided its carried interest model meets the policy requirements set out above and constitutes a sufficiently important element of incentive, then the relevant Annex II principles (see our paragraph 138 below) are satisfied in respect of the whole of that AIFM's incentive arrangements i.e., including any other elements of variable incentive such as annual cash bonuses. An AIFM would only be able to reach these conclusions based on a consideration of all the circumstances and on a case-by-case basis. In that light, we note the discussion in paragraphs 33 to 36 of ESMA's Cost-Benefit Analysis (in Annex VI to the CP).

18. For PE/VC firms, this is the logical approach, since in practice incentives and sharing of risks come as a package negotiated with sophisticated investors during the fund-raising process. Salary and any cash bonus are funded out of the fees paid by the AIF to the AIFM, which are negotiated and agreed with these investors up front. On the basis of these negotiations, the AIFM has a "fixed" income level (not based on non-market tested valuations or trading revenues) and the AIFM is entitled to decide the ratio of salary to bonus as it wishes: the split affects nobody except the private owners of the AIFM, who will likely be amongst the Identified Staff. Excessive risk-taking or caution does not affect the management fee.

19. As each PE/VC AIFM raises a new fund at approximately 3 to 5 year intervals, the opportunity to participate in carried interest does not arise in every performance year, and distributions will not be made in every year. That fact makes it hard to apply the risk alignment, award and pay-out principles on an element-by-element basis in relation to each element of variable incentive, and supports our argument that the elements of incentive should be regarded as a package. The fact that carried interest arrangements, sharing of risks and incentives are in place is relevant to the AIFM's satisfaction of the risk alignment requirements in relation to all variable remuneration. In any event, since carried interest is normally the most important incentive element for Identified Staff, there is no need to apply requirements such as vesting, deferral and retention separately to cash-based variable remuneration.

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Relationship of carried interest to other forms of equity-linked incentives

20. We note that a number of PE/VC groups include AIFs or other group members that have publicly listed securities. Some of these groups may use stock options or other traditional equity-linked incentives in addition to or instead of carried interest. We request that the final Guidelines specifically address the role that such tools can play in addition to carried interest.

Scope of Identified Staff

21. There is no legal basis for the suggestion that the AIFMD remuneration principles might be extended to staff of delegates of the AIFM, and we strongly object to this idea. We note that the CEBS guidelines on CRD III contain no similar provisions.

22. We would welcome ESMA's clarification of the interplay between AIFMD and the CRD in light of Article 11(1)(d) of the Level 1 text, and in particular that Identified Staff in a PE/VC AIFM subject to the AIFMD principles will not also be subject to CRD III.

Disclosure of Remuneration

23. We understand that DG paragraph 152 on disclosure of remuneration is intended to refer only to disclosure to relevant investors, not to disclosure to the general public (which would go beyond the Level 1 text). We request that this be clarified. It should be noted again that PE/VC AIFs covered by the AIFMD are not open to the general public; they are comprised of sophisticated professional investors who negotiate their rights, including disclosure, individually and with advice from outside counsel.

Transitional Arrangements

24. We suggest that the Guidelines include a specific reference to the possible need for AIFMs to apply appropriate transitional arrangements, for instance with respect to amounts of variable remuneration awarded after July 2013 but in respect of previous periods under pre-existing contractual arrangements.

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Specific Response to Sections and Questions

25. We have not answered every question, but only those which we consider to be relevant to PE/VC.

II. Section II - Background

Q1: Do you agree with the approach suggested above for developing the present Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.

26. We welcome ESMA's approach to developing the Guidelines, including due adaption of the CEBS guidelines on CRD III to reflect the differences between the non-bank asset management sector and the banking sector, and the differences between the text of CRD III and AIFMD. However, although ESMA's approach considers the specificity of the asset management sector, the asset management sector is very broad, and we are concerned that ESMA does not sufficiently take into account the different business models of AIFMs (e.g. hedge funds, real estate funds, private equity and venture capital).

27. One of the most important concerns of investors in a private equity and venture capital AIF is the alignment of interests. As a result, investors and fund managers in the PE/VC industry have together developed a risk-sharing and incentive model (of which carried interest is an integrated part) aimed at achieving this. The carried interest structure has proven to be an effective way of achieving this alignment of interests. Investors are, therefore, concerned that this carried interest model will be compromised, resulting in them being in a far less secure position than at present. Please refer to the introduction to our response in which we address this key concern. We very much welcome that ESMA recognizes generally that carried interest models should be deemed to be compliant with CP Sections IX and X, however certain clarifications are still necessary to correctly reflect reality (please see our response to question 46 below).

IV. Section IV - Scope of the Guidelines

IV.I. Which remuneration? - General remarks

28. We wish to stress that in a PE/VC context carried interest is not "remuneration" in any ordinary sense of that word. It is a share of the actual capital gains realised from an AIF's underlying investments. However, we accept that carried interest can and should be taken into account for the satisfaction of the alignment-of-interest and other principles set out in Annex II to the AIFMD.

29. We also understand that in ESMA's view typical PE/VC carried interest models are intended to be caught by Article 4(1)(d) of the Level 1 text even though it only refers to carried interest being received by the AIFM and suggests that carried interest in the meaning of the AIFMD is not a return on investment.

30. We note, however, that there is no provision in the AIFMD including carried interest in the definition of remuneration. On the contrary, paragraph 2 of Annex II makes an explicit distinction between "remuneration" and other "amounts paid directly by the AIF itself". To avoid technical inaccuracies and potential confusion, we encourage ESMA in its final

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Guidelines to avoid formulations which suggest that "remuneration" for the purpose of the Level 1 text is necessarily "in exchange for professional services rendered by the AIFM staff" or by way of "compensation for management of the AIF". The Level 1 text applies to incentives of that type but also (for understandable regulatory policy reasons) to carried interest, even though it does not exhibit those characteristics. We suggest that the final Guidelines include language such as the following in DG paragraph 10:

"…solely for purposes of Annex II, remuneration consists of all forms of payments or benefits paid by the AIFM to identified staff of the AIFM, including payments of carried interest made by the AIF and any transfer of units or shares of the AIF, in exchange for professional services rendered by the AIFM's identified staff to the AIFM, and these guidelines apply also to carried interest to the extent that the AIFM's identified staff participate in it."

By adopting the formulations we suggest, ESMA will reduce the risk that some advisers might encourage alternative asset management firms to attempt to avoid the AIFMD principles on the basis of a narrow construction of the language used.

31. Most PE/VC AIFMs are owner-managed businesses. Accordingly, in certain jurisdictions, the AIFM itself (*i.e.*, as well as the AIF) is structured as a partnership, limited liability partnership or similar. Returns to owners of the AIFM which are not by their nature remuneration should not be treated as such. We request that ESMA include a paragraph similar to paragraph 17 of the CEBS guidelines on CRD III, appropriately broadened to take account of the wide variety of PE/VC structures, as set out below:

"Consideration must also be given to the position of sole proprietorships, partnerships and similar structures. Returns on equity and similar interests, depending on the legal structure of the institution or entity, are not covered by these guidelines (unless they represent a vehicle for circumvention)."

Q2: Do you agree with the above considerations on the scope of the Guidelines? In particular, do you agree with the clarifications on what should be considered as a remuneration falling into scope and what should be considered an ancillary payment or benefit falling outside the scope of the Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.

32. No. The treatment of carried interest in paragraphs 19 to 24 of the CP contains a number of confusing and incorrect statements. This treatment is also unsupported by the Level 1 text, in which "carried interest" is defined in Article 4(1)(d) but is not described as "remuneration." In fact, as discussed above, carried interest is not remuneration in any ordinary sense of the word but represents a share in the returns made by the AIF. Instead, we support the approach taken in paragraphs 191-193 of the CP and DG paragraph 150, which indicate that requirements in relation to variable remuneration may be met by qualifying carried interest structures, without defining whether any or all "carried interest" should be characterized as remuneration.

33. We disagree with ESMA's contention in CP paragraph 20 (and DG paragraph 12) that only "pro rata" returns on investment will be excluded from the definition of carried interest under the AIFMD. Under Article 4(1)(d), "carried interest" is defined to exclude "<u>any share in the profits</u> of the AIF accrued to the AIFM as a return <u>on any investment</u>...into the AIF" [our emphasis]. AIFMs (representing also their Identified Staff), and AIF investors (who are sophisticated professional investors typically advised by very experienced counsel) may

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agree on different levels of profit sharing based on a variety of factors. The Level 1 text recognises this fact. The Guidelines may not deviate from the clear wording of the Level 1 text in this way.

34. We request that ESMA clarify the references in CP paragraph 19 and DG paragraph 11 to "ancillary payments or benefits that are part of a general, non-discretionary, AIFM-wide policy and pose no incentive effects". We understand these payments or benefits to include such things as health club memberships, health, disability or life insurance, home leave allowances, etc.

35. At the end of CP paragraph 20 (and DG paragraph 12), ESMA addresses the fact that an investment by AIFM staff in the AIF may be funded by a loan from the AIFM and indicates that returns on such an investment will not be excluded from treatment as carried interest if the loan has not been (fully) reimbursed by the time the return is paid. We submit that this approach is unduly narrow, for a number of reasons. Returns on investment may be paid over an extended period, and it would not make sense to apply this test when the first returns are received. Similarly, loans may be repayable on a wide variety of schedules. Returns on investments funded by a loan should only be excluded from treatment as carried interest if and to the extent the loan is forgiven by an AIFM.

36. In addition, it is important that CP paragraph 23 (DG paragraph 15) is not construed as applying to business models already legitimately used by the private equity industry even where this may result in carried interest payments falling outside the scope of the Guidelines. Anti-avoidance provisions should be limited to arrangements "which aim at artificially evading the requirements of AIFMD" and should not be applied more broadly.

Q3: Do you see any benefit in setting a quantitative or qualitative threshold at which the portion of the payment made by the AIF exceeding the pro-rata investment return for the investment made by the relevant staff members is transformed into carried interest? If yes, please make suggestions on the threshold to be used.

37. No, this would be entirely artificial and is not needed for all the reasons explained above (see notably points 28 to 31).

Q4: Do you agree that the AIFMD remuneration principles should not apply to fees and commissions received by intermediaries and external service providers in case of outsourced activities?

38. Yes, we agree. Such payments do not fall within the scope of Article 13 AIFMD, but rather Article 20 AIFMD (if at all).

39. In general terms, it is not clear when the non-core activities of an AIFM should be construed as being "outsourced" and / or when it is appropriate that an AIFM should have responsibility for, or influence over, the remuneration policy of a supplier, which may be separately regulated in another jurisdiction.

Q5: Notwithstanding the fact that the provisions of the AIFMD seem to limit the scope of the principles of remuneration to those payments made by the AIFM or the AIF to the benefit of certain categories of staff of the AIFM, do you consider that the AIFMD remuneration principles (and, therefore, these Guidelines) should also apply to any payment made by the

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AIFM or the AIF to any entity to whom an activity has been delegated by the AIFM (e.g. to the remuneration of a delegated investment manager)?

40. We strongly disagree with the suggestion that the AIFMD remuneration principles should apply to any payment made by the AIFM or the AIF to delegates of the AIFM. ESMA suggests that the provisions of the Level 1 test "*seem to **limit the scope** of the principles of remuneration to those payments made by the AIFM or the AIF to the benefit of **certain categories of staff of the AIFM***" [our emphasis]. In fact, this is clearly the intention and effect of Article 13(1) AIFMD. We note that ESMA does not advance any arguments otherwise in the CP. As a practical matter, in many cases an AIFM will have no power to impose remuneration policies on its delegates. The appropriate controls over delegation by an AIFM are established in Article 20 of the Level 1 text (to be supplemented by delegated acts). Article 20 AIFMD makes no provision about the remuneration arrangements employed by delegates. The CEBS guidelines on CRD III similarly do not apply to staff of entities to which a covered institution delegates functions.

41. We assume that Q5 is posed in the context of concerns that variable remuneration could be paid through vehicles or methods which aim at artificially evading the requirements of the AIFMD (within Annex II, paragraph (1)(r)). We note ESMA's reference in CP paragraph 23 (and DG paragraph 15) to "the use of tied agents or other persons not considered "employees" from a legal point of view". Any such concern about avoidance by means of inappropriate delegation would be better addressed by clarifying who are the "staff of the AIFM" for the purposes of Article 13 AIFMD and Annex II (of which a subset are "Identified Staff", see below). We suggest that this could be:

    "any natural person who is employed or appointed by the AIFM in connection with the AIFM's performance of its portfolio management or risk management functions, whether under a contract of service or a contract for services or otherwise, but excluding arm's-length service providers."

42. Article 20 AIFMD provides sufficient safeguards in relation to delegation and this Guidance should not purport to supplement it. There is no basis for this in Level 1. Such an approach could also lead to a layering of regulatory obligations where the delegate is also regulated.

Q6: Do you consider that payments made directly by the AIF to the AIFM as a whole (e.g. payment of a performance fee or carried interest) shall be considered as payments made to the benefit of the relevant categories of staff of the AIFM and, therefore, fall under the scope of the AIFMD remuneration rules (and, therefore, of these Guidelines)?

43. We are puzzled by the suggestion that payments of fees by the AIF to the AIFM should be considered to be payments made for the benefit of AIFM staff. It is not clear what ESMA contemplates. We suspect that the question might have been posed in light of the deficient definition of "carried interest" in Article 4(1)(d), which assumes that carried interest is only paid by the AIF *to the AIFM*. In some cases, carried interest is in fact distributed directly by the AIF to Identified Staff.

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IV.II. Which entities and which staff to be identified?

Q7: Do you agree with the categories of staff identified above which should be subject to the remuneration principles set out in the Guidelines? If not, please state the reasons for your answer and also suggest an alternative approach.

44. We welcome ESMA's recognition in DG paragraph 19 (and CP paragraph 31) that members of AIFM staff will not be Identified Staff, irrespective of title or the amount or structure of their remuneration, if they have no material impact on risk profile. We assume that, in the final Guidelines, DG paragraph 19 (CP paragraph 31) should be amended to refer to the possibility that a member of staff of the AIFM will be Identified Staff if they have a material impact on the risk profile <u>of the AIF and/or</u> the AIFM.

45. In the third bullet point under DG paragraph 19 (and CP paragraph 31), ESMA refers to "control functions" as amongst Identified Staff. We believe that the reference should be to "Heads of control functions" or to "Staff responsible for heading the control functions", which would be consistent with an assessment of impact on risk profile. Otherwise, all of the Guidelines will apply to all junior staff in control functions, which cannot be correct. We note that ESMA does distinguish in DG paragraphs 63 to 65 between "control function personnel" and "senior staff responsible for heading the control functions" but it does not do so elsewhere.

46. We believe that ESMA goes too far in the fourth bullet point under DG paragraph 19 (and CP paragraph 31) by identifying heads of administration and marketing as Identified Staff, since these staff will invariably not have a material impact on risk profile (unless they are also senior management within the second bullet point). It is unlikely that many general partners of private equity partnerships would have staff covering all the functions anticipated by the Guidelines as most private equity firms run small operations and the circle of "Identified Staff" is thus likely to be quite small (for example, in France 90% of the private equity and venture capital management companies have less than 10 employees). Therefore we consider this item as one where ESMA should fully apply the proportionality principle as defined in paragraph 1 of Annex II.

IV.III.Timing of entry into force of these Guidelines

Q8: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section IV (Scope of the Guidelines) would imply.

47. Extending the scope of the rules to capture all forms of remuneration (including carried interest insofar as it is relevant) would not *per se* significantly increase the (not insubstantial) burden placed on AIFMs by the Guidelines; especially if applied in a proportionate manner. That said, the inclusion of carried interest within the scope of the rules will have little, if any, impact on the risk profile of private equity partnerships as it is already aligned with the interests of investors and paid out of investment returns (DG paragraph 150, CP paragraph 192).

48. Decision taking by private equity funds is usually circumscribed by investment and advisory committees (as applicable), so there is very little scope for the actions of any individual employee to create risk in the manner anticipated. Article 13 AIFMD is clearly more appropriate in a mutual funds or UCITS context.

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V. Section V - Proportionality principle

V.I. Proportionality in general

49. We agree that it is primarily the responsibility of the AIFM to assess its own characteristics and to develop and implement remuneration policies and practices which appropriately align risks and provide adequate and effective incentives to staff (DG paragraph 25). We note in this regard that the EU law principle of proportionality applies to the application of all EU law requirements.

50. We acknowledge that the proportionality principle does not mean that AIFM can disregard any of the guidelines. However, we consider it disproportionate for DG paragraph 23 (and CP paragraph 36) to require each AIFM to prepare a written explanation for tailored application of the AIFMD remuneration principles on an item-by-item, line-by-line basis. This will be unduly costly and produce no particular benefit. In particular, we anticipate that Member State competent authorities, trade associations or groups of AIFM might wish to develop further guidelines on proportionality for particular categories of firm, to which an AIFM might cross-refer in general terms. Firms should therefore be expected instead to address explicitly in the formal remuneration policy approved by the governing body (in accordance with DG paragraph 34) how they have arrived at a tailored application of the principles. This explanation should be proportionate to the degree of tailored application they have undertaken and sufficient for the relevant competent authority to supervise the AIFM's compliance with Article 13 AIFMD.

51. The description of carried interest vehicles in DG paragraph 24 (and CP paragraph 37) is unduly restrictive, and it fails to take account of the wide variety of structures in the PE/VC sector. PE/VC AIFMs and AIFs may be listed or privately held. They typically enter into heavily negotiated agreements with sophisticated investors, but a limited number sell "off-the-shelf" products. Carried interest structures can also vary significantly depending on the structure of the AIFM. We submit that the key point is that the proportionality principle, as a general principle of EU law, is capable of applying to each and every principle under Annex II (to the extent that it can be reconciled with the risk profile, risk appetite and strategy of the AIFM and each of the AIFs it manages).

V.II. Proportionality with respect to the different characteristics of AIFMs

52. We consider it very important that ESMA should elaborate on the criteria relevant to an assessment of proportionality in DG paragraph 26 (and CP paragraph 41). As noted above, PE/VC structures vary significantly. We suggest that ESMA should elaborate on the assessment of complexity by reference to the investment strategies employed by the AIFM, the frequency of transactions undertaken for the AIFM, the number of AIFs managed by the AIFM, the number of investors in those AIFs, and the extent to which the AIFM is a listed vehicle, a partnership or owner-managed business.

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Q9: Do you agree with the clarifications proposed above for the application of the proportionality principle in relation to the different criteria (i.e. size, internal organisation and nature, scope and complexity of activities)? If not, please state the reasons for your answer and also suggest an alternative approach.

53. The principle of proportionality underpins the whole of Annex II. The legislative requirement is that AIFMs comply with the principles set out in Annex II "*in a way and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities*". We consider the proportionality principle to be an essential tool for ensuring firms adopt effective and workable remuneration practices that reflect and are appropriate to their differing risk profiles and governance structures, and we believe ESMA's Guidelines can and should go further in this respect.

54. As noted in paragraph 4 of the Consultation Paper, Article 13(2) of the AIFM Directive expressly requires ESMA to reflect the proportionality principle in its Guidelines and also requires ESMA to cooperate closely with EBA. Paragraph 7 of the Consultation Paper indicates that ESMA has placed particular focus on the CEBS guidelines on CRD III in developing the draft Guidelines.

55. The proportionality requirement in Annex II of the AIFM Directive is phrased in identical terms to the proportionality requirement in Annex V, paragraph 23 of the Banking Consolidation Directive, which similarly requires firms to comply "*in a way and to the extent that is appropriate to their size, internal organisation and the nature, the scope and the complexity of their activities*". We believe the ESMA Guidelines should follow more closely the approach to proportionality adopted in the CEBS guidelines, and consider that Article 13(2) of the AIFM Directive gives ESMA a clear mandate for doing so.

56. In contrast to CP paragraphs 36 and 37 of the draft ESMA Guidelines, which indicate only that requirements may be "tailored", paragraph 20 of the CEBS guidelines clearly states that the application of the proportionality principle may lead to certain requirements being "neutralized" if this is reconcilable with the risk profile, risk appetite and the strategy of the firm. Paragraph 20 of the CEBS guidelines goes on to identify those requirements that may, in appropriate circumstances, be neutralized, as follows:

- *'The requirements on the pay-out process, discussed under section 4.4., starting from paragraph 114. This kind of neutralization can be based on either "proportionality between institutions" (as explained in 1.2.2. below) or "proportionality between categories of staff" (as explained in 1.2.3. below). This means that some institutions, either for the total of their Identified Staff or for some categories within their Identified Staff, can put aside the requirements on*
  - *variable remuneration in instruments;*
  - *retention;*
  - *deferral;*
  - *ex post incorporation of risk for variable remuneration.*
- *The requirement to establish a remuneration committee (hereafter 'Rem Co'), as discussed from paragraph 52 of these guidelines.'*

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57. As recognised by the European Commission in its explanatory memorandum accompanying its initial proposal for AIFMD as well as by the de Larosière report, given the absence of systemic risk posed by PE/VC, we do not believe there is any justification for imposing more stringent requirements on PE/VC investment fund managers than are imposed on banks. We therefore believe that CP paragraph 37 (DG paragraph 24) in the final ESMA Guidelines should reflect the approach taken by the CEBS guidelines, permitting requirements to be “neutralized” (rather than only “tailored”) where this can be justified by reference to the size, internal organisation and risk profile of the firm.

58. We also consider that the sections of the draft Guidelines relating to Shareholders’ Involvement (Section VIII.I.C) and the establishment of a Remuneration Committee (Section VIII.II) should be included in CP paragraph 37 (DG paragraph 24) of the Guidelines, which lists those requirements that may be tailored/neutralized (noting again that the CEBS guidelines permit the RemCo requirement to be neutralized). This is necessary as many private equity firms are owner-managed businesses operating under a partnership model. Such firms do not have external shareholders or non-executive directors, and hence these requirements are largely inappropriate for this type of firm.

V.III. Proportionality with respect of the different categories of staff

Q10: Do you agree with the clarifications proposed above for the application of the proportionality principle to the AIFM’s categories of staff? If not, please state the reasons for your answer and also suggest an alternative approach.

59. We broadly agree with the approach taken, based on our understanding that CP paragraph 43 (DG paragraph 28) is intended to be a non-exhaustive indication of the types of factors that may be taken into account. We request that ESMA state expressly in the final Guidelines that these factors are non-exhaustive.

Q11: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section V (Proportionality principle) would imply.

60. As stated above, we consider the proportionality principle to be fundamental to effective implementation of the AIFMD remuneration requirements. The primary benefit of this approach is that it both encourages and requires firms to implement the requirements in a tailored and thoughtful way, and we believe this increases the likelihood of firms’ remuneration arrangements achieving the intended risk alignment objectives overall. Requiring firms to comply with rules that simply do not fit their governance structures would have no discernable benefit for investors or other stakeholders, and would impose significant costs on firms.

VI. Section VI – AIFMs being part of a group

Q12: Do you agree that there is a need for consistency in the potential application of different requirements for AIFMs which belong to a group subject to other principles?

61. We agree that there is a need for consistency.

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Q13: Do you agree that the proposed alignment of the CRD and AIFMD remuneration provisions will reduce the existence of any conflicting remuneration requirements at group level for AIFMs whose parent companies are credit institutions subject to the CRD? If not, please state the reasons for your answer and provide quantitative details on any additional costs implied by the proposed approach.

62. We have two concerns about overlapping and potentially conflicting requirements concerning remuneration deriving from AIFMD and CRD.

63. First, whilst we agree with CP paragraph 29, we suggest that ESMA address one further aspect of the interaction between AIFMD and MiFID. It is our understanding that a particular AIFM could be subject at the same time to the remuneration principles of AIFMD (and the present Guidelines) and the remuneration principles under CRD. This is because of the application of Article 11(1)(d) of AIFMD, which provides that the competent authorities of a Member State may withdraw the authorisation of an AIFM where the AIFM "no longer complies with [the Capital Adequacy Directive] 2006/49/EC if its authorisation also covers the discretionary portfolio management service referred to in point (a) of Article 6(4) of [AIFMD]". In line with ESMA's approach in DG paragraph 29, it would be helpful if ESMA could make clear that AIFMs performing Article 6(4) activities that comply with the final Guidelines will be deemed to satisfy the CRD requirements. The proper interpretation of Article 11(1)(d) is important not only to pay regulation, of course. It has an important bearing on the regulatory capital requirements applicable to the AIFM.

64. Second, there may be circumstances in which a member of Identified Staff of an AIFM is also a member of Identified Staff of a different institution which is a credit institution or CAD investment firm. For example, the two institutions may be grouped and an individual may be an officer of both. Or the AIFM may be part of a CRD consolidation group and the individual's professional activities may pose a risk to the group on a consolidation basis. In a situation like this, only one set of rules should apply in respect of the relevant individual, and the parent institution should be able to decide which set of rules is most appropriate. The draft Guidelines do not address this point in respect of individuals "wearing two hats" (dealing only with the separate point that one set of sectoral rules should not apply to an affiliate subject to a different set of rules). It is not clear that the paragraph of the CEBS guidelines quoted in CP paragraph 47 deals with the point either. We suggest a further paragraph to be inserted in the final Guidelines after DG paragraph 29 as follows:

"If an individual is Identified Staff in respect of two or more firms affiliated with each other, the parent undertaking may decide to apply only one set of sectoral rules to the remuneration of that member of Identified Staff, taking into account the risks his activities pose to the entities."

Q14: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VI (AIFMs being part of a group) would imply.

65. It is not yet practicable to estimate the costs implied by the proposed rules.

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VII. Section VII - Financial situation of the AIFM

General Remarks

66. As ESMA has recognised elsewhere in the CP, not all incentive categorised as "remuneration" for the purposes of the AIFMD derives from the AIFM. To the extent that payments move from the AIF directly or indirectly to Identified Staff, for example carried interest, its vesting will not have any impact on the balance sheet or financial situation *of the AIFM*. For that reason, we suggest that DG paragraphs 30 to 32 (CP paragraphs 48 to 51) should be expressly qualified so that they apply "so far as relevant to a particular element of remuneration". Alternatively, this concern could be addressed by making clear that in the final Guidelines DG paragraph 150 (CP paragraph 192) is capable of satisfying the requirements under the heading "Financial situation of the AIFM" (see our paragraph 140 below).

Q15: Do you agree with the above principle aimed at preserving the soundness of the AIFM's financial situation? If not, please state the reasons for your answer and also suggest an alternative approach.

67. In a private equity context, the AIFM is typically entitled to 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 AIFM (office space, salaries and bonuses of staff etc.). The main method of aligning interests and providing a variable incentive is through the carried interest models as further described elsewhere in this response. Carried interest is a share in the cash profits of the AIF for which the fund manager is typically only eligible once investors have received their capital (including typically also amounts drawn to pay the management fee) back plus any preferred return. In addition, carried interest entitlements are sometimes directly held by Identified Staff without affecting the financial situation of the AIFM.

68. Whereas we do not disagree on ESMA's principles, investors and fund managers achieve these through a combination of the management fee and carried interest models which have been designed to achieve a strong alignment of interests between both parties.

Q16: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VII (Financial situation of the AIFM) would imply.

69. It is not yet practicable to estimate the costs implied by the proposed rules.

VIII. Section VIII - Governance of remuneration

General Remarks

70. Most AIFMs are small. Many have only a handful of senior staff. Most PE/VC AIFMs are independent owner-managed businesses, in many cases structured as partnerships, limited liability partnerships, or limited liability companies. ESMA's DG section X (and CP section VIII) is very difficult to apply generally and, in particular, because:

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(a) it places too much emphasis on the distinction between the governing body (also referred to as the "management body") and senior management, who, in a partnership environment, may be the same people;

(b) it assumes the governing body "in its supervisory function" will include non-executive members, which in certain jurisdictions and with certain structures may not be typical for these AIFMs, and in particular not for PE/VC AIFMs; the role is not mandatory when there are no external shareholders and, depending on their precise remit, may not be acceptable to investors;

(c) consequently, even in large AIFMs, there are examples of AIFMs where there will rarely be any members of the management body who do not perform executive functions from whom a Remuneration Committee could be drawn;

(d) it would, in any case, be inappropriate for non-executives to be responsible for protecting the interests of investors (per CP paragraph 12), as this would create a conflict with their fiduciary obligations to shareholders;

(e) DG section X (CP section VIII) contemplates that such non-executive members will be compensated only with fixed remuneration, which may or may not be the case;

(f) ESMA does not recognise that, in small firms, senior managers (or even partners) may be both front office executives and responsible for certain control functions, for example being in charge of the compliance function. These structures are equally successful in ensuring that the staff in charge of control functions have sufficient authority, access and influence. The potential for conflict of interest must be managed, of course, but remuneration restrictions must not be excessively prescriptive.

71. ESMA does recognise (for example in CP paragraph 55) that an AIFM may not have a separate governing body acting in a supervisory function. In these cases, the draft Guidelines provide that the governing body's functions should be performed by the "person or persons in charge of the management body". We assume this means the AIFM's chief executive officer, managing partner or equivalent. We would welcome clarification but, even if clarification is provided, the draft Guidelines will remain artificial and difficult to apply to the majority of AIFM which do not have two-tier boards, let alone those in jurisdictions where this is not the norm. We suggest that ESMA should revisit CP section VIII, sub-sections A, B and C (and the corresponding sections of the draft Guidelines), and substantially simplify them and clearly indicate that AIFMs have flexibility in applying these principles in line with the principle of proportionality.

72. In DG paragraph 49 (CP paragraph 74), ESMA gives examples of AIFM that need not establish a Remuneration Committee. The fact that an AIFM might be an owner-managed business, partnership or limited liability partnership is a further factor which might indicate that it is not significant enough to establish a Remuneration Committee. It would be helpful if ESMA could give this as an example.

73. We consider the proposed amount of EUR 250 million AUM (in DG paragraph 49, CP paragraph 74, first bullet point) as a threshold for significance in this context to be much too low, in particular for PE/VC groups that will normally be exempt from the AIFMD entirely where their assets under management are under EUR 500 million. This is totally disproportionate compared to thresholds used for the same purpose in other parts of

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financial service regulation. We suggest that no numerical threshold be included. If one is included, however, we believe that it would be appropriate to provide a higher threshold for PE/VC AIFMs proportionate to the thresholds set out in Article 3(2) AIFMD. Thus, if the threshold for other AIFMs were set at EUR 250 million AUM, the AUM threshold for PE/VC AIFMs would be EUR 1.25 billion. In any event, irrespective of any such numerical threshold, we believe that also the number of staff should be taken into account, and given the lack of systemic risk (see paragraph 57), the in-built investor protections and limited size of PE/VC management companies (see paragraph 46), all PE/VC AIFMs that have 20 employees or less should be outside the threshold.

74. We also note that Member States should be permitted to allow AIFMs in their jurisdiction to comply with requirements relating to the composition of RemCos on a "comply or explain" basis, as is the case with listed companies.

VIII.I. Management body

Q17: Do you agree with the proposed split of competences between the members of the management function and those of the supervisory function? If not, please provide explanations.

75. It is understood that the existence of a supervisory function separate from the management function (also referred to as "the management body" and "the governing body") is subject to proportionality. The application of proportionality is welcomed in this area.

Non-executives

76. From CP paragraph 55 it is understood that, where a separate supervisory function does not exist, for the purposes of CP paragraphs 56 to 81 inclusive, references to the supervisory function should be read as references to the person, or persons, in charge of the management function.

77. CP paragraph 57 (DP paragraph 34) states "The remuneration policy should not primarily be controlled by executive members of the supervisory function." This seems to imply that in all cases (both where there is a separate supervisory function and where the supervisory function is fulfilled by the management function), the supervisory function should consist of non-executive members.

78. Owner-managed businesses do not, as a rule, have non-executive directors, as the role is redundant where there are no external shareholders. Consequently, even in large AIFMs (many of which are owner-managed businesses), there will rarely be any members of the management body (or supervisory function where this exists) who do not perform executive functions.

79. In any case, where non-executives do exist, it would be inappropriate for them to be responsible for protecting the interests of investors in the AIFs (as per CP paragraph 12), as this would create a conflict with their fiduciary obligations to shareholders.

80. In light of the above, we would welcome confirmation that proportionality will apply to the requirement for non-executives both where there is, and where there is not, a separate supervisory function.

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Collective sufficient knowledge of remuneration

81. It is understood (from CP paragraph 55) that, where a separate supervisory function does exist, it should include (a) non-executive members and (b) these members should collectively have sufficient knowledge of remuneration policies.

82. With regard to (a), please refer to our previous comments regarding non-executives in our paragraphs 76above.

83. With regard to (b), we would welcome confirmation that proportionality will apply to this requirement. If it does not, the requirement may prohibit non-executives from being members of the supervisory function simply due to their insufficient knowledge of remuneration policy. Given the supervisory function has responsibilities other than that of remuneration policy, this is likely to detract from the quality of the supervisory function as a whole. For example, smaller businesses may have a separate supervisory function already, but may be insufficient in size or complexity for that supervisory function to consist of a sufficient number of experts on remuneration. We believe that knowledge of remuneration in the industry sector should be sufficient for this purpose.

Fixed remuneration

84. We welcome the proposed application of proportionality with regard to the fixed remuneration of the supervisory function (CP paragraph 63, DP paragraph 40). We note this is likely only to be applicable to the largest of firms which already have non-executive members as is currently the norm in the listed environment for example.

Q18: Do you agree with the guidelines above on the shareholders' involvement in the remuneration of the AIFM?

85. We are in agreement with the above Guidelines insofar as the shareholders' involvement is not obligatory (although it may be obligatory due to other existing rules of the jurisdiction in which the AIFM is established). We would welcome explicit confirmation that proportionality applies to these Guidelines as they are not referred to as examples of where proportionality does apply (at CP paragraph 37, DG paragraph 24).

86. It would not be appropriate for these Guidelines to have a greater scope than the rules for listed companies in any jurisdiction. It is for example noted that, under the current rules for companies listed in the UK, the shareholder vote on the policy for directors' remuneration is advisory, not binding.

VIII.II. Remuneration Committee

Q19: Do you agree with the criteria above for determining whether or not a RemCo has to be set up? If not, please provide explanations and alternative criteria.

87. We agree with the proportionality principle being applied in this case. Furthermore, both examples set out at CP paragraph 74 (DG paragraph 49) are welcomed as instances where a RemCo would not be necessary.

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88. We note the first example gives a value of the portfolios under management of EUR 250 million as a measure for the AIFMs who would not be subject to this rule (assuming the value of the portfolios they manage does not exceed this). It is likely that a large number of AIFMs will fall outside this category, but also be unlikely to require a RemCo on grounds of proportionality. Accordingly, a higher minimum threshold may be more appropriate (see paragraph 73 above).

Q20: Do you agree that in assessing whether or not an AIFM is significant, consideration should be given to the cumulative presence of a significant size, internal organisation and nature, scope and complexity of the AIFM's activities? If not, please provide explanations and alternative criteria.

89. We agree that the above factors should be taken into consideration when assessing the significance of an AIFM for the purposes of this test. Please also refer to our response to question 9 and our general remarks under Section VII.

Q21: Please provide quantitative data on the costs and benefits that the proposed criteria to determine whether a RemCo has to be set up would imply.

90. For the avoidance of doubt, we understand this question relates to the costs and benefits of assessing (against the proposed criteria) whether a RemCo is required and not of the costs and benefits of the RemCo's existence itself.

91. Regarding costs, it is difficult to quantify the costs of the proposed criteria given the lack of detail. It is expected that the more specific the criteria are made, the lower the costs would be. If external consultants input were required (e.g. if criteria remain vague), this would have a higher cost than criteria that could be assessed internally.

92. Regarding the benefits, it is assumed the intended benefit of assessing whether a RemCo is required is ultimately the independence the RemCo may bring to the setting and review of remuneration policy and the RemCo's contribution to protecting investors (as referred to in CP paragraph 12). Providing meaningful quantitative data on such qualitative benefits is unlikely to be possible.

Q22: Do you see merits in adding further examples of AIFMs which should not be required to set up a RemCo? If yes, please provide details on these additional examples.

93. There would be merits in adding further examples of exemption. For example, it would be useful if it were confirmed that the exemption applies to AIFMs with a portfolio with a value greater than EUR 250 million, but which do not have a separate supervisory function.

Q23: Do you agree with the principles relating to the composition of the RemCo? Please provide quantitative data on the costs and benefits that the proposed principles on the composition of the RemCo would imply.

94. Where a separate supervisory function already exists and contains sufficient independent members (see answer to Q17 above), the principles for the composition of the RemCo are agreed.

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95. It is noted that the corresponding rules for UK listed companies are "comply or explain". It would not be appropriate for the rules for privatively held AIFMs to go beyond those applicable to public companies by enforcing a set composition.

96. Where a separate supervisory function does not already exist, or does not contain sufficient non-executives and/or independent members, it is assumed that a RemCo would not be required, although it may be recommended.

97. Having to include non-executives in e.g. the RemCo or the remuneration policy not primarily being controlled by executive members in the supervisory functions implies for many AIFMs having to add positions/persons/staff to fulfil these roles. Therefore, the costs of the RemCo would depend, to a large extent, on the fees paid to these independent non-executives and whether they already sat on the supervisory function (see answer to Q17).

98. It is assumed the intended benefit of the composition of the RemCo is the independence this may bring to the setting and review of remuneration policy ultimately intended to protect investors (as set out in CP paragraph 12). Providing meaningful quantitative data on such qualitative benefits is unlikely to be possible.

Q24: Do you see any need for setting out additional rules on the composition of the RemCo?

99. No, we do not see a need for any additional rules on the composition of the RemCo.

Q25: Do you agree with the role for the AIFM's RemCo outlined above? If not, please provide explanations.

100. Our response to this question is only in the context of where a RemCo is actually required, *i.e.*, broadly speaking very large AIFMs only and subject to the points raised in the answer to Q17 above.

101. The first point of CP paragraph 79 (DG paragraph 54) requires more clarification on the definition of "highest paid staff members". Does this phrase refer to a set number of employees (*e.g.*, the top five highest paid) or those paid above a certain threshold (e.g. with total remuneration exceeding EUR 1 million)? Clarity is required in this area to ensure that all AIFMs can take a consistent approach.

102. We do not agree with the final requirement of CP paragraph 79 (DG paragraph 54) for the RemCo to formally review a number of possible scenarios and to test the remuneration system. This would be an onerous task for a RemCo to properly comply with. By way of comparison, for example, it goes further than the requirements for UK listed companies.

103. The other requirements seem reasonable, subject to further clarification on the process for determining whether a RemCo is required at all.

Q26: Do you agree with the principles above on the process and reporting lines to be followed by the RemCo? If not, please provide explanations.

104. We see no issues arising from the suggested principles on the process and reporting lines to be followed by the RemCo.

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Q27: Do you consider that the AIFM's RemCo should provide adequate information about the activities performed not only to the AIFM's shareholders' meeting, but also to the AIFs' shareholders' meetings? When providing your answer, please also provide quantitative details on the additional costs involved by such requirement.

105. AIFM's shareholders' meeting: Where an AIFM already has a requirement for such a meeting, it is agreed that it would be appropriate for a RemCo to provide adequate information to this meeting (as would be the case already). If there is no such requirement, then we do not consider it appropriate.

106. AIFs' shareholders' meeting: Where there is such a meeting, we consider that the requirement for an AIFM to disclose remuneration policies in its annual report (CP paragraph 194) should be sufficient for the AIFs' shareholders and that any further provision of information at AIFs' shareholder meetings would be unnecessary. In addition, for a corporate body of the AIFM to report to the shareholders' meeting of a different legal entity would conflict with established corporate law principles and potentially create conflicts of interest.

VIII.III. Control functions

107. DG paragraph 63 (and CP paragraph 89) goes too far in stating that variable remuneration for staff in control functions should not be determined by the individual financial performance of the business area they monitor. As noted above, the structures of PE/VC firms vary widely. Many PE/VC AIFMs have only one business area, so this would inhibit any element of incentive being tied to overall firm performance. This would be particularly difficult in small firms where senior staff perform multiple functions (see our paragraph 70 above). Indeed, allowing all Identified Staff to participate in the results of the AIFs in which investors participate is the optimal way to align their interests. We request that in the final Guidelines DG paragraph 63 (CP paragraph 89) should be amended to provide that:

"If staff in control functions receive variable remuneration, it should be based at least in part on function-specific objectives and should not be based solely on AIFM-wide performance or the performance of any particular business area."

In the second sentence of DG paragraph 64, by contrast, ESMA contemplates that a component of remuneration of staff in control functions may be based on AIFM-wide performance criteria, subject to appropriate management of conflicts of interest. There appears to be a tension between DG paragraphs 63 and 64. We support the approach in paragraph 64.

108. An alternative way to address this concern in the PE/VC context would be to make clear in in the final Guidelines in DG paragraph 150 (CP paragraph 192) that carried interest is capable of satisfying the AIFMD's policy objective (see our paragraph 140 below). Using carried interest to incentivise control staff is the ideal solution, since using "function-specific objectives" could create its own difficulties. For example, if the objective is to minimise breaches, this could create an incentive to under-report or ignore matters which may be breaches to keep the metric low; if the objective is to root out non-compliant behaviour, this could create an incentive to take a hard line on all matters to show the work that is being done.

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109. We suggest that in the final Guidelines DG paragraph 68 (CP paragraph 94) should be amended by adding the underlined wording below:

"Control function personnel should not be placed in a position where, for example, approving a transaction, making decisions or giving advice on risk and financial control matters could be directly linked to an increase or decrease in their performance based remuneration, where the controlled function personnel member could reasonably be expected to be incentivised to take a decision adverse to the interests of the AIF or its investors."

Q28: Do you agree with the above criteria on the remuneration of the control functions? If not, please provide explanations.

110. In general, we agree that the remuneration structure of control function personnel should not create conflicts of interest in their advisory role. However, we do not agree that the remuneration of the control functions should only be based on functions-specific objectives and not be linked to the performance of the business area they are supposed to control. If the risk alignment is ensured we do not see the requirement to prohibit control function remuneration linked to the performance of the business area. A risk manager who has invested his/her own money will be even more careful to ensure that no unnecessary risks are being taken and that guidelines are being met. It is not clear to us why a risk manager who is paid less than others would be a better risk manager than one that is being paid like all others. We agree that – like any other employee – a risk manager should be paid less in case he/she poorly performs his/her functions but that does not mean that he/she cannot participate in carried interest payments in case he/she performs properly.

Q29: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section VIII (Governance of remuneration) would imply.

111. It is not yet practicable to estimate the costs implied by the proposed rules.

IX. Section IX - General requirements on risk alignment

General Remarks

112. As discussed in the introductory remarks to this response, the PE/VC industry, through negotiations with well-advised sophisticated investors conducted over many years, have developed a structure that is ideally suited to align the interests of investors with those of AIFMs and their staff. We welcome ESMA's recognition of this fact but request a number of minor changes to avoid technical inaccuracies and to ensure that the Guidelines provide the necessary flexibility to allow for the range of structures negotiated by AIFMs and their investors.

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IX.I. The basic principle of risk alignment

Q30: Do you agree with the principles related to the treatment of discretionary pension benefits? If not, please provide explanations.

113. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

IX.II. General prohibitions

Q31: Do you consider appropriate to add any further guidance on the payments related to the early termination of a contract? If yes, please provide suggestions.

114. When a staff member leaves the AIFM before retirement the discretionary pension benefit vested to the staff member should not always be subject to a five-year retention period; however, in regards to retirement ESMA should be aware that the requirement to defer for five years the discretionary pension benefit vested to the staff member might contradict existing national labour law which already provides for early release mechanisms. In this respect, we would like to refer to recital 28 of the AIFMD which states that: "The provisions on remuneration should be without prejudice to (…), general principles of national contract and labour law, applicable legislation (…)".

Q32: Do you consider that the above guidance is sufficiently broad to cover any kind of hedging strategies that may be pursued by a member of the staff of an AIFM? If not, please provide details on how the scope of the guidance should be enlarged.

115. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q33: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section IX (General requirements on risk alignment) would imply.

116. It is not yet practicable to estimate the costs implied by the proposed rules.

X. Section X - Specific requirements on risk alignment

General Remarks

Specific requirements on risk alignment

117. Please refer to our comment in our paragraph 66 above. The description in DG section XI (CP section IX) of the risk alignment, risk measurement and performance measurement process is not directly applicable to those elements of incentive which consist of units in the AIF or distributions from the AIF, such as carried interest. The mechanisms for risk

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sensitivity are individually negotiated with sophisticated investors at the outset and built into the fund structure. Whilst we appreciate that section XI of the draft Guidelines is subject to the proportionality principle, it would help if this section of the final Guidelines could be qualified so that it applies "so far as relevant to a particular element of remuneration". An alternative way to address this concern would be to make clear in the final Guidelines in DG paragraph 150 (CP paragraph 192) that carried interest is capable of satisfying the requirements in this section (see our paragraph 140 below).

118. DG paragraph 127 (and CP paragraph 165) refers to the fact that for many AIFs (and this will include almost all PE/VC AIFs) share-linked instruments are not an option due to the legal form of the fund (in the PE/VC context closed-ended and with a long life) and, even where they are available, it may be difficult to value them. ESMA contemplates that, in these cases, alternative instruments may be used that reflect the AIF's value and have the same intended effect as share-linked instruments. We anticipate and hope that most PE/VC firms will not need to grapple with this issue because of the application of DG paragraph 150 (CP paragraph 192) concerning use of carried interest structures. However, in a minority of cases, PE/VC firms will need to use alternative instruments.

119. In that context, we would welcome clarification in DG paragraph 127 (CP paragraph 165) as to the type of arrangement ESMA has in mind. The most likely arrangement in a PE/VC context is a "synthetic carried interest scheme", being a long-term cash bonus scheme. This is a purely contractual arrangement between the AIFM and Identified Staff. Any bonus will be referable to a notional carried interest return (as opposed to the value of units in the AIF, which would be impossible to value for the reasons previously given). Such cash bonus schemes are not regarded for most purposes as "instruments". We propose that ESMA refers in DG paragraph 127 (CP paragraph 165) to "synthetic carried interest schemes structured as long-term cash bonus schemes" and not to refer exclusively to "instruments".

120. In addition, to the extent that Identified Staff are owners of the business (*e.g.*, partners in a partnership), it is unnecessary for the AIFM to enter into bespoke long-term cash bonus schemes of the sort described in the previous paragraph in order to incentivise staff to ensure the success of the AIFM and its AIFs. This is because partners are owners (not merely in the "owner-like position" referred to in CP paragraph 162). As noted in paragraph 31 above, we propose that the final Guidelines include a paragraph similar to paragraph 17 of the CEBS guidelines on CRD III.

121. In DG paragraph 125 (and CP paragraph 163), ESMA requires that, for AIFMs managing several AIFs, Identified Staff should receive instruments related only to the AIF in relation to which they perform their activities. In the case of closed-end funds with a life of several years, it may not always be practicable to give exposure to "alternative instruments" which relate to the performance of a closed fund. For example, this may be challenging if a particular executive joins the AIFM towards the end of the life of a ten-year fund. We suggest that in the final Guidelines DG paragraph 125 (CP paragraph 163) could be qualified by saying that Identified Staff "*should typically receive instruments related to the AIF(s) in relation to which they perform their activities*".

122. It should also be noted that a few PE/VC groups have publicly listed shares or other equity interests. The Guidelines should make clear that such shares or other instruments can also be used to satisfy relevant requirements.

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X.I. Fully flexible policy on variable remuneration

123. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

X.II. Risk alignment of variable remuneration

Q34: Do you consider these common requirements for the risk alignment process appropriate? If not, please provide explanations and alternative requirements.

124. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q35: Do you agree with the proposed criteria on risk measurement? If not, please provide explanations and alternative criteria.

125. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q36: Do you agree that in order to take into account all material risks AIFMs should also take into account the risks arising from the additional management of UCITS and from the services provided under Article 6(4) of the AIFMD?

126. We have no specific comments from the perspective of the PE/VC industry.

Q37: Do you agree with the proposed guidance for the financial and non-financial criteria to be taken into account when assessing individual performance? If not, please provide explanations and alternative guidance.

127. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q38: Do you agree with the proposal to distinguish between absolute and relative performance measures on one side and between internal and external performance measures on the other? If not, please provide explanations.

128. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

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X.III. Award process

Q39: Do you agree with the requirement set out above to document the policy for the award process and ensure that records of the determination of the overall variable remuneration pool are maintained? If not, please provide explanations and an alternative procedure.

129. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q40: Do you agree with the proposal according to which AIFMs should use both quantitative and qualitative measure for the ex-ante risk adjustment? If not, please provide explanations and an alternative proposal.

130. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

X.IV. Pay-out process

Q41: Do you agree with the guidance on the different components to be considered in relation with the deferral schedule for the variable remuneration? If not, please provide explanations and alternative guidance.

131. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q42: Do you agree with the types of instruments composing the variable remuneration which have been identified by ESMA? If not, please provide explanations.

132. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

133. We note, however, that there is no basis in Level 1 for the proposal in paragraph 163 to prohibit Identified Staff receiving "instruments" related to AIFs other than those in respect of which they provide services (or indeed any specific form of remuneration) so long as the principles set out in Annex II of the AIFMD and the requirements related to conflict of interest set out in Article 14 of Level 1, are otherwise respected. Indeed, the prohibition in paragraph 163 could be difficult to implement in the context of a group that conducts a variety of different types of activities.

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Q43: Do you consider that additional safeguards should be introduced in these Guidelines in order to ensure that the payment of the Identified Staff with instruments does not entail/facilitate any excessive risk-taking by the relevant staff in order to make short-term gains via the instruments received? If yes, please provide details.

134. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q44: Do you agree with the proposed guidance for the retention policy relating to the instruments being a consistent part of the variable remuneration? If not, please provide explanations and alternative guidance.

135. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

Q45: Do you agree with the proposed guidance for the ex-post risk adjustments to be followed by AIFMs? If not, please provide explanations and alternative guidance.

136. We have no specific comments from the perspective of the PE/VC industry, provided that the Guidelines' provisions on the treatment of carried interest and the Annex II principles for which carried interest structures can be taken into account are modified as proposed below to ensure the necessary degree of flexibility.

X.V. Compliance of certain remuneration structures with the requirements on risk alignment of variable remuneration, award and pay-out process

Q46: Do you agree with the analysis on certain remuneration structures which comply with the criteria set out above? If not, please provide explanations.

137. We refer to the introduction to this response for general comments on carried interest structures and their treatment under the Guidelines.

Significance of carried interest for other aspects of the Guidelines

138. We are concerned that references:

(a) in DG paragraph 150 to those sections of the guidelines under the headings "Risk alignment of variable remuneration", "Award process" and "Pay-out process";

(b) in CP paragraphs 191 and 192 to sections X.II to X.IV; and

(c) in CP paragraph 193 to paragraphs 1(l) to (o) of Annex II to the AIFMD,

are all unduly narrow. PE/VC carried interest models may also be relevant to the satisfaction of other requirements of Annex II of the AIFMD and the Guidelines, including certain requirements under the headings "Financial situation of the AIFM", "Governance of

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remuneration" and "Fully flexible policy on variable remuneration". For example, the use of carried interest structures is relevant to the requirements that:

(i) AIFMs' remuneration policies should be in line with the business strategy, objectives, values and interests of the AIFM, not encourage excessive risk taking as compared to the investment policy of the AIFs the AIFM manages, and enable the AIFM to align the interests of the AIFs and their investors with those of the Identified Staff that manages such AIFs, and to achieve and maintain a sound financial situation (DG paragraph 36, CP paragraph 59);

(ii) Variable remuneration of staff in control functions "should be based on function-specific objectives and should not be determined by the individual financial performance of the business area they monitor" (DG paragraph 63, CP paragraph 89);

(iii) "[T]he remuneration of those staff members in compliance and risk management functions must be designed in a way that avoids conflict of interests related to the business unit they are overseeing and, therefore, should be appraised and determined independently" (DG paragraph 65, CP paragraph 91); and

(iv) At least 50% of any variable remuneration shall consist of equity-linked instruments related to the AIF (paragraph (1)(m) of Annex II)).

Technical concerns with the way in which carried interest is described

139. We are also concerned that certain technical aspects of the description of carried interest in DG paragraph 150 (and CP paragraph 192) are not entirely accurate and may have unintended consequences.

(a) Commonly, part of any carried interest due may be advanced to the relevant holders to enable them to pay taxes triggered in such jurisdictions as the carried interest accrues (*i.e.*, after award but prior to vesting). In various countries, this is an inevitable consequence of the application of tax laws that would otherwise require individuals to fund tax payments on money that they have not yet received and may never receive, usually with no right to a tax refund, if the carried interest payment does not vest.

(b) Holders of carried interest will of course also receive salary, and some may receive annual cash bonuses or other elements of variable incentive from the AIFM. In many cases, particularly where (as is increasingly common) a second generation of AIFM staff become the so-called "key men and women" in respect of a new AIF, it is vital that they should be able to receive cash bonuses.

(c) We are concerned about the description of carried interest as being received by way of "compensation for the management of the relevant AIF", which is technically incorrect since the AIFM's management services are actually compensated through the management fee. Whilst this language is used, erroneously, in the definition of "carried interest" in Article 4(1)(d) AIFMD), it would be helpful if ESMA were not to perpetuate its use unnecessarily.

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Proposed solution

140. In light of all of these concerns, we suggest that in the final Guidelines DG paragraph 150 (CP paragraph 192) should read as follows:

"While it is necessary to have regard to all the relevant circumstances case-by-case, certain guidelines may be satisfied in relation to the whole of an AIFM's variable incentive arrangements (i) where the most important element of variable incentive is intended to be carried interest, (ii) where the arrangements are contractually agreed to by investors, and (iii) where:

(a) such carried interest accrues only after the AIFM first returns to the investors of the AIF all capital contributed by those investors to the AIF and an amount of profits at a previously agreed preferred rate of return (if any); or

(b) to the extent all or any portion of such carried interest is paid prior to the end of the life of the relevant AIF, it is subject to appropriate arrangements (such as claw-back or escrow arrangements) to protect investors, or is paid only to fund related tax obligations."

The guidelines that may be satisfied in this manner include but are not limited to the guidelines under the headings "Risk alignment of variable remuneration", "Award process" and "Pay-out process" and aspects of the guidelines under the headings "Design, approval and oversight of the remuneration policy" and "Remuneration of control functions".

141. We understand through discussions with ESMA that sub-paragraphs (a) and (b) of DG paragraph 150 (and CP paragraph 192) are not intended to be read as conjunctive, *i.e.*, the intention is not to have cumulative "belts and braces". That being the case, it would help to correct the final Guidelines by using the disjunctive "or" instead of "and". If that change were made, it would go some way (but not all the way) towards meeting some of the concerns identified in the preceding paragraphs.

Q47: Do you consider that there is a need for submitting to an equivalent/similar treatment any other form of remuneration? If yes, please provide details of the remuneration structure(s) and of the specific treatment that you consider appropriate.

142. As noted above, a few PE/VC groups have publicly listed AIFs or parent companies, and stock options or similar instruments may form part of the incentives of AIFM staff. We request ESMA to address the treatment of such incentives combined with carried interest in the final Guidelines.

Q48: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section X (Specific requirements on risk alignment) would imply.

143. It is not yet practicable to estimate the costs implied by the proposed rules.

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XI. Section XI – Disclosure

144. As a general remark, we refer to the introductory remarks in this response pointing out that investors in the PE/VC sector are highly sophisticated and negotiate the terms on which they invest on an individual basis, usually with the assistance of outside advisors. This negotiation process includes not only the payment of fees and carried interest, but also disclosure requirements. Disclosure requirements will be further addressed in the delegated acts to be adopted by the European Commission. We respectfully submit that it is not necessary for the Guidelines to impose further requirements in relation to disclosure.

XI.I. External Disclosure

145. We strongly oppose the suggestion (see CP paragraph 196 and DG paragraph 152) that AIFMs should make any public disclosure about remuneration (as opposed to disclosures in the annual report to investors and to relevant regulators). There is no basis in the Level 1 text to require public disclosure and no sound policy justification for it. There is no basis in the Level 1 text because Article 22(1) contemplates that the AIFM must provide a copy of the annual report to investors (on request) and to regulators. The second sub-paragraph of Article 22(1) then provides a choice for an AIFM to the extent that such AIFM is required to publish financial statements in accordance with Directive 2004/109/EC. That choice is reflected in the use of the words "either separately or as an additional part of the annual financial report". Only if the AIFM opts to use the financial statement is any public disclosure to be made. It is open to such an AIFM to provide the information in Article 22(2) to investors by other, non-public means if it wishes. Article 22 reflects the outcome of negotiations on this specific point during the legislative process at Level 1.

146. Even in the context of CRD, there may be sound prudential reasons why a credit institution or investment bank should disclose information about its remuneration policies and procedures, and certain qualitative data. This may be relevant to counterparties and prospective counterparties to the firm when it deals on its own balance sheet, and the disclosures may contribute to the reduction of systemic risk. There is no such policy justification in the case of AIFMs, which deal exclusively as agents. They will be required to make disclosures in the context of investor protection and this objective is adequately addressed by disclosure in the annual report, to investors and regulators (as Level 1 requires). We note that the Recommendation refers to "relevant stakeholders". In the context of an AIFM, the relevant stakeholders are the investors in its AIFs.

XI.II. Internal Disclosure

Q49: Do you consider appropriate to require AIFMs to apply the same level of internal disclosure of remuneration as they apply to their external disclosure? Please state the reasons of your answer.

147. We do not consider it appropriate to require the same level of internal disclosure as is made in disclosures to investors or regulators. Many of the remuneration principles in relation to which ESMA contemplates external disclosure do not directly concern most individuals. For example, it is not relevant to most staff to explain remuneration governance; and it is of no concern to front office staff how colleagues in control functions are remunerated independent of the businesses they oversee. These are matters for senior management, regulators and investors. It is also unlikely to be appropriate to explain the remuneration structures of those senior to a particular individual. We agree that staff

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members should know in advance the criteria that will be used to determine their own remuneration, and that the appraisal process should be properly documented and transparent to the member of staff concerned. However, disclosure to staff in the breadth and degree of detail contemplated by ESMA for reporting to investors and to regulators in a supervisory context is unnecessary and could be confusing.

Q50: Please provide qualitative and quantitative data on the costs and benefits that the rules proposed in this Section XI (Disclosure) would imply.

148. It is not yet practicable to estimate the costs implied by the proposed rules.

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.

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Submission

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