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Department for Work and Pensions Policy Group
Private Pensions and Arm's Length Bodies Directorate
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By email: pensions.investment@dwp.gsi.gov.uk

27 March 2019

Dear Ms Donnelly, Mr Farrar

Re: BVCA response to DWP consultation on "Investment Innovation and Future Consolidation: A Consultation on the Consideration of Illiquid Assets and the Development of Scale in Occupational Defined Contribution Schemes"

We are writing on behalf of the British Private Equity and Venture Capital Association (BVCA), the industry body and public policy advocate for the venture capital and private equity industry in the UK. We represent the vast majority of all UK-based firms (over 770), as well as their professional advisers and investors. Over the past five years (2013-2017), BVCA members have invested over £32bn into nearly 2,500 companies based in the UK. Our members currently back around 3,380 companies in total, employing close to 1.4 million people on a full-time equivalent basis (FTEs) across the world. Of these, around 692,000 FTEs are employed in the UK. Of the UK companies our members invested in during 2017, around 83% were SMEs.

We warmly welcome Government intervention in this area

We fundamentally believe that the UK's pension framework should allow the beneficiaries of defined contribution (DC) schemes to benefit from the illiquidity premium that investments in unlisted companies can offer. That premium has been available to defined benefit (DB) scheme participants via venture capital and private equity funds for decades. We also see ever-increasing demand for private capital to fuel the growth of UK businesses, particularly at the venture and growth stages of their development, and note the disproportionate role that capital from non-UK pension funds currently plays in meeting that demand (as evidenced below). We therefore welcome the DWP's moves, in the context of parallel work within Government, the British Business Bank and the FCA, to remove some of the barriers preventing DC pension savers from investing in patient capital and other illiquid assets.

The 'illiquidity premium' in venture capital and private equity

The latest BVCA data show that UK venture capital and private equity funds continue to demonstrate, on a since-inception basis, a high level of consistency in performance, with returns tending to hover in a band around approximately 15% per annum (net of fees) over the past decade[1]. US research reinforces this conclusion, showing how allocations to private assets can improve investment performance:

- Data from US endowments and foundations provided to Cambridge Associates[2] showed that portfolios with more than 15% allocated to private investments have outperformed their peers consistently, and for decades. Cambridge attributed the outperformance to venture capital,

[1] BVCA Performance Measurement Survey 2017 – available here
[2] The 15% Frontier, July 2016 - available here

private equity, and distressed securities far outperforming public asset classes, earning annualised returns of 12.5%, 11.9%, and 10.8% respectively over the last 10 years.

- Analysis performed in 2013 by Willis Towers Watson[3] looked at the asset allocations of a subset of large plan sponsors for 2010 and 2011, comparing DB and DC plan performance to simulated investment returns. Using an asset-weighted measure of returns, DB plans outperformed DC plans by an annual average of 76 basis points from 1995 to 2011. The report noted that DB plan sponsors have been replacing equities with more fixed-income and alternative investments to diversify their investment portfolios and better match assets to liabilities. The report also highlighted that public equity holdings are smaller in DB plans than in DC plans.

Research on risk in private equity carried out by Montana Capital Partners and the BVCA has found that across a diversified portfolio of fund investments, the risk of losing capital can be brought down below 1%, and that levels of funding risk become predictable and manageable. In addition, the research also shows that for a suitably diversified portfolio of fund investments, the risk of an investment not being able to realise its valuation can be brought below 1%.[4]

UK pension funds lag behind their international peers for investing in illiquid assets

Internationally, the pension funds industry already benefits from investments in UK-based venture capital and private equity funds to a much greater extent than the level of UK pension fund investment in our industry would suggest. A mere 3.7% of the £33 billion raised by UK-based venture capital and private equity funds in 2017 came from UK pension funds. In contrast, a much larger proportion (36.5%) came from overseas pension funds, 87% of which was from *public* pension funds (31.7% of the total).[5] This is despite data from Willis Towers Watson showing that the UK has the second largest pensions market in the world, with $3.1 trillion of pension assets (81% DB versus 19% DC)[6]. The potential for UK managers to raise greater amounts of capital from UK pension funds therefore seems clear.

The charge cap is our industry's key concern with the DWP proposals

Increased reporting around UK schemes' approaches to investing in illiquid assets would be a welcome driver of more pro-active engagement by trustees with longer-term, unlisted investments. We also agree that scale is an important pre-requisite to increasing investment flows from DC savers into patient capital. So is specialist trustee knowledge and understanding of investing in illiquid assets, which consolidated schemes could achieve more easily. However, we defer to other respondents on how these objectives might be achieved.

The charge cap is our members' key concern within the DWP's mandate. Our response to this consultation therefore focusses on the questions relating to the charge cap.

[3] Insider, May 2013 – available here

[4] BVCA & Montana Capital Partners, Risk in Private Equity, 2015 – available here

[5] BVCA report on Investment Activity 2017 – available here

[6] Global Pensions Assets Study 2018 – available here

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

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

We have explained this further below and have included an Appendix setting out the structure, function and effectiveness of carried interest arrangements in greater detail.

Q6. To what extent are performance fees used or required for funds which offer illiquid investment such as venture capital, infrastructure, property, private debt and private equity? Are market practices changing?

In the Appendix, we describe in detail the principles behind the economics of the traditional European venture capital and private equity fund model. Funds in this industry are typically closed-ended, and this response is restricted to that type of structure. There are some variations in some funds, which tend to be based on circumstances such as the particular stage in the economic cycle that a fund is raised, or the size and strategy of each fund. However, market practice regarding the basic carried interest model has not changed significantly for the past thirty-five years. This fact in itself demonstrates that investors consider carried interest a fair and effective method of aligning the interests of the fund manager and fund investors, and of driving the strong returns that the venture capital and private equity industry has consistently delivered.

There is a perennial debate over whether carried interest can correctly be characterised as "essentially a performance fee", given that one of its functions is to reward fund managers for good performance. This view is understandable, but ignores the legal basis of carried interest as a partnership profit share, as well as the fundamental differences between venture capital and private equity, and other income-based or liquid assets as investment propositions.

Carried interest is a mechanism for long-term alignment (not a daily/regular performance measure)

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

This arrangement has arisen because the performance of a venture capital or private equity investment depends heavily on the amount and quality of the portfolio management work that the fund manager does after it has made the investment decision (as well as having made a good initial investment decision). This work helps the company fulfil its initial promise and strategic plans, grow in value and therefore provide returns based on capital appreciation to the fund's investors when the company is sold, usually at the conclusion of a three to five year business plan (or longer in the case of some patient capital funds) put in place on investment. It is critical to both fund managers and investors that a fund manager is incentivised to continue to work hard, for many years after the investment decision, to increase the value of the fund and its investors' capital in the company by exercising the fund's ongoing influence over the company (or very often control, as the majority shareholder). This is why carried interest in the traditional UK/European fund model does not unconditionally[7] reward fund managers with any share of a fund's profits of a fund until the fund manager has returned investors' capital plus the preferred return. Further performance is eventually rewarded in cash as a minority share of the fund's further profits once investments have been realised, if, and only if, the investment decisions, and subsequent multi-year effort of the fund manager in growing the businesses in the fund's portfolio, have succeeded in returning the entirety of investors' capital and delivering them the agreed preferred return.

Carried interest is symmetric

Carried interest is treated as remuneration under the Alternative Investment Fund Managers Directive. It is recognised as meeting the remuneration regulatory requirements covering: deferral arrangements: retention; and malus/ex-post incorporation of risk for variable remuneration. This is covered in more detail in the Appendix.

To use the language of the consultation paper, carried interest is also a "symmetric" system. The operation of the fund-as-a-whole model, alongside clawback and escrow provisions, means that any disparity in performance between portfolio companies is netted off at the end of the fund's life to ensure that fund managers are in effect penalised for poor performance to the same extent as they are rewarded for "outperformance". The fund manager is further incentivised to avoid poor performance through a co-investment obligation. This has arisen from investors' insistence that fund managers invest as an investor in their funds themselves, so that the manager stands to lose its own capital if the fund delivers negative returns over its life (see the Appendix for more detail on how these mechanisms typically work), thus sharing in downside risk, as well as the upside.

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

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

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

As mentioned above, this response focusses on the closed-ended fund structure that is dominant in our industry. Open-ended vehicles do exist, but the traditional, fund-as-a-whole model for calculating carried interest does not work for such “evergreen” vehicles, which would need to calculate performance fees in some other way, perhaps by reference to the increase in NAV over a more appropriate, measurable period rather than a daily NAV.

The process for making and managing investments is intensive and requires significant resources and expertise

Executing an investment decision for a venture capital or private equity fund can take a fund manager many months. It invariably involves: conducting specialist research to source corporate M&A deals in private markets; evaluating risks; analysing historic financial data as well as calculating detailed projections; developing business plans; carrying out extensive due diligence with hired lawyers, accountants and other advisers; leading detailed and often protracted negotiations of transaction terms; arranging debt finance facilities; structuring the investment appropriately (taking into account investors’ circumstances); and a range of other activities. This is incomparably more involved and expensive than conducting research (albeit skilled and specialist) and ordering the execution of a trade by a broker, and requires sustained activity.

Both venture capital and private equity funds make investment decisions with the express intention of gaining substantial influence or control over private companies. This is because our industry’s investment proposition involves fund managers using that influence or control in conjunction with their own expertise and networks to grow and thereby increase the value of the private companies, post-acquisition. A portfolio company’s period of venture capital or private equity ownership typically involves the company’s new venture capital or private equity shareholders/owners: making arrangements for operational, governance and other issues uncovered during the due diligence process to be resolved; the development of the company’s strategic objectives; refining and implementing a multi-year business plan; investing in capital expenditure; identifying and filling gaps in board expertise; supporting ESG initiatives and deploying ESG experts where required; renegotiating existing finance arrangements and agreeing new ones; and many other activities. This continues throughout the period of ownership, which concludes with a further corporate M&A process to execute the fund’s exit from the investment. All this activity is usually overseen by and one or more specialist executives (and often a highly experienced non-executive chairperson) that the fund manager will appoint to the board of the company as a representative of the fund and in many cases supported by a portfolio management team. The level of hands-on ongoing activity inherent in venture capital and private equity fund managers’ management of their investments is therefore much greater than that required of many other types fund manager.

Carried interest payments cannot be calculated prospectively for the charge cap

The timing of carried interest payments, towards the end of the life of the fund, is designed to incentivise the fund manager to maintain this level of commitment and activity throughout the fund’s period of holding an investment. Crucially, for DC pension schemes, this also means that

carried interest cannot meaningfully be measured on an ongoing basis for the purposes of the charge cap. This timing works as an incentivisation tool but is also an unavoidable practical reality, as the performance of a venture capital or private equity fund's portfolio investment is uncertain until the company (and generally the fund's portfolio as a whole) is sold.

The industry's periodic fair value valuations are an estimate of the ongoing value of portfolio companies that allows investors some way of monitoring how their investment in a fund is progressing, but is insufficiently certain to form the basis for rewarding the fund manager's performance. Carried interest payments cannot be based on an ongoing fair value assessment of what the fund's overall return is likely to be. This is quite simply because that overall return in closed ended structures will not be known until all the multi-year business plans of all the fund's portfolio companies have been completed, and the companies sold on the open market to the best bidder at the time.[8]

From a legal perspective, carried interest is the general partner's share in a fund's profits with the limited partners of a partnership registered as a limited partnership. The carried interest vehicle can also be a separate partner in the limited partnership. Carried interest is therefore legally not a performance fee but a profit allocation.

Q7. To what extent is the charge cap compliance mechanism a barrier to accessing funds which charge a performance fee? Does this act as a barrier to accessing certain asset classes?

The current compliance mechanism does not work and these proposals seem unlikely to address this challenge

We welcome the DWP's willingness to explore solutions to this problem, but believe that the proposal to modify the prospective method of compliance to allow performance fees to be included up to the level of the charge cap will not facilitate DC schemes' access to venture capital and private equity funds. As long as carried interest is erroneously categorised as a performance fee and therefore included in the charge cap calculation, it will not be possible for DC schemes to invest directly in traditional venture capital and private equity funds under the charge cap compliance mechanism. This is because it is not possible to predict accurately what the level of carried interest will eventually be in relation to a particular closed-ended fund, until after the fund has realised all of its portfolio companies, at the end of the fund's life. This approach is a barrier to accessing traditional venture capital or private equity funds, because they are unable to calculate, in advance, what a scheme member's maximum annual fee burden would be.

In theory, such investments could be possible if a DC scheme were able to invest in an interposed authorised fund vehicle that itself invested in venture capital and private equity funds. If such a vehicle were categorised as a professional investor for regulatory purposes, in theory, it could invest directly into venture capital or private equity funds using DC scheme capital. This would only be the case if the interposed vehicle were able to construct a blended portfolio of assets where the total fee level gave sufficient headroom to include a large carried interest allocation, whilst remaining below the cap. However, the fact that, in theory, carried interest payments are unlimited in size, and in practice their timing and value cannot be known in advance, poses significant challenges to this potential structure. The effect of the charge cap is to place more emphasis on the payment of management fees over carried interest or performance fees, at a time when investors in closed-

[8] Or listed on an exchange.

ended funds are increasingly demanding the opposite, in order to further increase managers' alignment with investors' interests throughout the fund's life.

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

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

The venture capital and private equity industry is global, and carried interest arrangements across the industry typically follow the principles set out above and in the Appendix. Carried interest is a long-established arrangement in this industry, which deliberately protects investors' interests. These arrangements are heavily negotiated between managers and professional investors, with the respective legal advisors. Requiring wholesale changes to structures that have operated successfully for investors over many years, including during periods of financial market stress, and are recognised by regulators and tax authorities, would be difficult to justify.

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

We believe that the best solution would be to exclude genuine carried interest arrangements from the charge cap, as well as any performance fees for any type of fund where their accrual or payment is reflected in net returns to investors (see our comments on funds of funds below). In parallel, DWP should also explore structures and mechanisms that would allow and encourage DC schemes to focus on the total net return, as well as enabling them to monitor ongoing fees. A focus on minimising ongoing fees does not reflect the proven potential of venture capital and private equity to deliver superior outcomes for investors by the end of the life of a 10+ year fund. The current system ignores this potential by counting carried interest as a charge that is subject to the cap.

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

Q8. Do you agree that we should permit the additional method of charges assessment? Do you envisage any problems with complying with this method of assessment, or any reasons why it might disadvantage members?

We appreciate the DWP's positive approach and recognition that the current method of assessment needs to be changed. However, we believe that the proposed method will not address the challenges, for the same reason as the current charge cap compliance method does not work for closed-ended venture capital and private equity funds, namely that carried interest is unquantifiable in advance. Please refer to our answer to question 7 for more detail.

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Q9. We propose that:
(a) We should publish guidance – which might carry statutory weight – on appropriate performance fee structures.
(b) We should in particular specify in statutory guidance that performance fees should be calculated and accrued each time the value of the fund is calculated.
(c) Performance-related fees should only be permitted alongside a funds under management charge, and not alongside contribution charges or flat fees.
We would welcome respondents' views on all these points.

Carried interest arrangements are negotiated between managers and their investors and they evolve over time. We prefer this market-driven approach over any legislative guidance which is unlikely to factor in bespoke requirements that the manager, fund strategy and the investors may have.

However, trustees may be understandably cautious about carried interest being unpredictable and unquantifiable in advance, because they risk breaching the charge cap if their scheme's investment in a venture capital or private equity firm performs too well. In this context, guidance, as long as it is not too prescriptive, has the potential to instil greater confidence that trustees can apply a practical approach to the charge cap calculation, and limit the extent to which they are discouraged from investing in high performing illiquid assets on an artificial basis. Such guidance could:

- Confirm that trustees are permitted to calculate the fees of all their schemes' underlying managers on a "blended" basis, so that higher fees attaching to venture capital and private equity funds can be offset by allocations to, for example, index funds. We appreciate that the guidance already touches on this, but we feel this point should be emphasised more strongly, in order to dispel the doubts that our members continue to encounter.

- Explicitly allow trustees to apply certain assumptions and a "probability discount" to arrive at a fixed fee equivalent of the projected carried interest or other performance, and then apply that over the life of the fund.

- Clarify that trustees will not face regulatory penalties or other negative consequences if an investment unintentionally exceeds the charge cap because the outperformance it delivers for scheme beneficiaries is too good (which seems a perverse outcome). Clearly, the greater the quantum of carried interest, the higher the net return to investors.

We are also concerned by proposal (c), as venture capital and private equity fund management fees are almost invariably calculated as a fixed percentage of investors' commitments to the fund in the earlier years of a fund's term, rather than on funds under management (see the Appendix for more detail). If carried interest or performance-related fees were not permitted where they were accompanied by flat fees, this would be a barrier to investment in closed-ended venture capital and private equity funds.

Q10. Do you believe that the updated non-exhaustive list of costs and charges provides increased clarity about the scope of the charge cap? Are there any areas where further clarity might be required?

We suggest trustees would find it easier to invest in funds-of-funds targeting illiquid assets if the managers of those funds were able to exclude the costs of underlying portfolio funds from the charge cap where those costs are in effect already reflected (i.e. they are accounted for in the NAV of those underlying funds).

We also believe there is a lack of clarity regarding the "Investment level payments…" item on the list of items within the scope of the charge cap. This seems to cover expenditure on items that are actually transaction costs in the illiquid assets context, such as fees for the third party professional services that are required to execute an M&A transaction to acquire / sell an unlisted company on behalf of the fund. This is akin to "Dealing commission and fees, including payments for goods and services provided in return, e.g. research", which are expressly excluded as transaction costs. We suggest the exclusion list be amended to clarify that third party advisory fees required to execute unlisted M&A deals are expressly excluded from the charge cap, as transaction costs.

We would be happy to discuss the contents of this letter with you; please contact Tom Taylor (ttaylor@bvca.co.uk).

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee

APPENDIX

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

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

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

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

- *Years 6 to 7:*
    - The investment period has ended and the fund starts to realise its investments (e.g. sell portfolio companies to trade buyers, list them on the stock market, etc.).
    - The cash proceeds from exits begin to be distributed to investors.
    - At this stage, the fund manager is not entitled to any share of these cash distributions because investors have not yet received back the value of their drawn down capital for all investments, management fee/PPS and other costs plus the agreed preferred return (typically 8% p.a.).
- *Years 8 to 9:*
    - The fund continues to realise its investments.
    - Investors have now received sufficient cash distributions to cover their drawn capital for all investments, management fee/PPS and other costs plus the agreed preferred return.
    - At this point, the fund manager becomes entitled to its percentage profit share (carried interest) of all future proceeds from realisations in line with the agreement made with investors at the start of the fund's life.
    - However, even then, some of the manager's carried interest entitlement is retained in an escrow account and only released to the fund manager once investors have received further cash distributions sufficient to cover any undrawn capital commitments which the manager could still draw down.
- *Years 9 to 10:*
    - The fund continues to realise its investments in portfolio companies.
    - Investors have now received sufficient cash distributions to cover their drawn down capital plus undrawn commitments (i.e. the total amount that they originally committed to the fund) and the agreed preferred return.
    - The fund manager and its executives receive the carried interest due on all proceeds from realisations, in the form of a profit share.
    - The fund is wound down once all its investments have been sold, at which point any proceeds held in escrow would be released to the carried interest participants.

How carried interest arrangements both protect investors and incentivise fund managers

The carried interest arrangements include a number of protections for investors that have become market-norms following negotiations between fund managers and investors over the years. These protections reflect investors' need to keep venture capital and private equity fund managers incentivised to work to help increase the value of portfolio companies over the long term. Carried

interest is treated as remuneration under the Alternative Investment Fund Managers Directive. It is recognised as meeting the remuneration regulatory requirements as explained below.

- *Deferral arrangements*

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

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

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

- *Retention*

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

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

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

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

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

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

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

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

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

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

- There is no common method by which the co-investment is funded. It will depend on the particular circumstances of the prospective participants and the level of the commitment.