

PROPOSED SEC RULES COULD LIMIT CARRIED INTEREST AND INCENTIVE COMPENSATION PAID BY PRIVATE EQUITY FIRMS

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While private equity professionals have been keenly aware in recent years of proposed changes to the U.S. tax code that could impact the taxation of carried interest, few in the industry have focused on the possibility that bonus or carried interest payments made to private equity professionals could become subject to limitations or other regulation under U.S. law. Yet, that scenario could develop if proposed rules from a range of federal agencies are adopted in their proposed form. Commenters have pointed out, however, the important distinctions between compensation practices at private equity firms, on the one hand, and at banks and other financial institutions, on the other, and have urged that the rules be modified before final adoption so that they are not inappropriately applied to private equity firms.

On April 14, 2011, the Securities and Exchange Commission (“SEC”) and several other federal agencies jointly published proposed rules aimed at governing incentive compensation practices at a broad range of banks and other financial institutions, including private equity firms.¹ The proposed rules were intended in part to address

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¹ Incentive-Based Compensation Arrangements, 76 Fed. Reg. 21,170 (proposed Apr. 14, 2011) (to be codified in scattered sections of 12 C.F.R.). The other agencies involved were the Office of the Comptroller of the Currency, the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the National Credit Union Administration, and the Federal Housing Finance

situations where employees at financial firms were perceived to have exposed their institutions to long-term risks in exchange for near-term fees to the institutions (and large near-term bonuses to the employees), leading to excessive risk taking and even, possibly, the risk of adverse impacts on the financial system should those institutions find themselves in material distress.²

The proposed rules implement Section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”),³ which prohibits certain incentive compensation arrangements that encourage inappropriate risks through excessive compensation or compensation that could lead to material financial loss. The SEC’s version of the proposed rules, approved by the SEC Commissioners in a 3-2 vote,⁴ covers both registered and unregistered investment advisers (including private equity firms) having \$1 billion or more of consolidated assets (“IAs”).⁵ Unless the scope of the proposed rules is narrowed in response to public comment, the new incentive compensation rules (other than the deferral provisions of the rules, which would apply only to very large IAs) could apply to a significant number of private equity firms.

During the public comment period, which closed on May 31, 2011, the SEC received extensive comments on the proposed rules, including in regard to their application to private equity firms.⁶ The SEC is conducting meetings with certain individuals and entities that submitted comments to discuss those comments and get answers to any follow up questions that the SEC may have.⁷ Although the Dodd-Frank Act required that the incentive compensation rules be adopted by the end of April 2011, the SEC currently plans to adopt final rules between January and June of 2012.

Scope and Impact of the Proposed Rules

The SEC’s version of the proposed rules limits compensation practices at covered IAs, as follows:

Prohibitions. Each IA is prohibited from establishing or maintaining incentive-based compensation arrangements for “covered persons” that encourage inappropriate risk by providing (1) excessive compensation or (2) compensation that could lead to a

Agency.

² *Id.* at 21,172.

³ Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 956, 124 Stat. 1376, 2011–1018 (2010).

⁴ Press Release, SEC, SEC Proposes Rules on Disclosure of Incentive-Based Compensation Arrangements at Financial Institutions (Mar. 2, 2011), <http://www.sec.gov/news/press/2011/2011-57.htm>.

⁵ 76 Fed. Reg. 21,172.

⁶ See *Comments on Proposed Rule: Incentive-Based Compensation Arrangements*, SEC (last updated Oct. 27, 2011), <http://www.sec.gov/comments/s7-12-11/s71211.shtml>.

⁷ See *id.*

material financial loss by the IA.⁸ A “covered person” means any executive officer, employee, director or principal shareholder (*i.e.*, a 10% or greater owner).⁹

The proposed rules specify six factors to consider when determining whether compensation is excessive.¹⁰ The factor most relevant to private equity firms is whether compensation arrangements are in line with industry practice. A private equity firm that has industry-standard compensation arrangements—a 20% carry allocated among investment professionals, and salaries and bonuses paid out of its 1.5% to 2.0% management fees—could take the position that its compensation arrangements are consistent with industry practice and, therefore, should not be deemed excessive. Under the rules as currently written, however, industry practice is only one of the factors that may be considered in determining whether compensation is excessive, leaving regulators considerable leeway to second-guess a private equity firm’s decisions concerning compensation arrangements. Other factors include the combined value of all cash and non-cash benefits provided to a covered person, the covered person’s compensation history, and the financial condition of the covered financial institution.

Reporting. Each IA must submit a brief annual report to the SEC describing the structure of its incentive-based compensation arrangements but is not required to disclose the compensation of particular individuals.¹¹ The annual report must describe the policies and procedures governing such arrangements and explain why the IA believes that those arrangements comply with the prohibitions against compensation that is excessive or that could lead to material financial loss by the IA.

Three-Year Deferral of Incentive-Based Compensation by Very Large IAs. IAs having \$50 billion or more in “consolidated assets” must defer at least 50% of the annual “incentive-based compensation” for executive officers (including the chief investment officer and chief legal officer) for a minimum of three years.¹² During the deferral period, the deferred amount must be adjusted (down) for (poor) performance.¹³ This deferral requirement appears to apply to annual bonuses paid to employees of the IA, but does not appear to apply to carried interest arrangements, since carried interest distributions should not be considered “annual” compensation.

Definition of Consolidated Assets. “Consolidated assets” means the IA’s “total assets” as reflected on the balance sheet for the IA’s most recent fiscal year end.¹⁴ Under GAAP as currently in effect, certain IAs, including private equity firms, are required to consolidate their affiliated funds if the limited partners of those funds do not have the

⁸ 76 Fed. Reg. 21,173.

⁹ *Id.* at 21,175.

¹⁰ *Id.* at 21,178.

¹¹ *Id.* at 21,177.

¹² *Id.* at 21,180.

¹³ *See id.*

¹⁴ *Id.* at 21,176.

right to remove the funds' general partner(s) without cause by a vote of a majority in interest (or less).

Only a very small number of private equity firms are likely to have balance sheets showing total assets of \$50 billion or more (the trigger for the deferral requirement) in the near term. However, a private equity firm that is required to consolidate third-party managed assets could become subject to the proposed rules as such third-party managed assets rise in value, absent (1) a change in the GAAP consolidation rules, which are under discussion, or (2) a change in the SEC's proposed rules, such as a change to make clear that for purposes of these rules, consolidated assets are deemed to include only the proprietary assets of the firm (even if GAAP requires that certain third-party managed assets be consolidated). Such proprietary assets would include the firm's investments in funds (and portfolio companies) that the firm manages, and exclude assets that the firm manages for third-party investors.

Definition of Incentive-Based Compensation. "Incentive-based compensation" means "any variable compensation that serves as an incentive for performance."¹⁵ The deferral requirement for larger IAs applies only to "annual" incentive-based compensation. Therefore the deferral requirements appear not to apply to private equity carried interest arrangements (since they should not constitute annual compensation), even if those arrangements are subject to vesting, as is typical. (Vested equity, including partnership interests that are already fully vested, also is not considered incentive-based compensation under the proposed rules.)

Policies and Procedures. Each IA must develop and maintain specified policies and procedures governing incentive-based compensation that are consistent with the restrictions of Section 956 of the Dodd-Frank Act.¹⁶ In addition, each IA with \$50 billion or more in total consolidated assets must have in place a process for the board of directors (or a committee thereof) to review and approve incentive-based compensation for covered persons who individually have the ability to expose the IA to losses that are substantial in relation to the IA's size, capital or overall risk tolerance.¹⁷

Public Comment

The SEC specifically requested public comment on various aspects of the proposed rules, including on:

- the proposed definition of "incentive-based compensation,"¹⁸
- whether the SEC should clarify that any specific forms of compensation are not

¹⁵ *Id.* at 21,175.

¹⁶ *Id.* at 21,201.

¹⁷ *Id.*

¹⁸ *Id.* at 21,176.

incentive-based compensation;¹⁹

- the proposed method of determining asset size for investment advisers, and whether the determination of total assets should be further tailored for certain types of advisers, such as private equity funds or hedge funds;²⁰
- whether there are additional factors that should be considered in evaluating if compensation is excessive or could lead to material financial loss;²¹ and
- whether it would be prudent to mandate deferred incentive-based compensation for certain types of covered financial institutions but not for other institutions (e.g., investment advisers) based on the business risks inherent to that business or other relevant factors.²²

The SEC received a great deal of public comment on the proposed rules, including from the private equity industry.²³ The comments focused on the following issues:

One Size Fits All. The most universally made comment was that the proposed rules' one-size-fits-all approach, sweepingly adopted by a wide range of regulators to be applied to an even wider range of institutions, does not adequately take into account the pronounced differences in the entities and industries to which the rules will apply. Commenters urged the SEC to consider the unique aspects of the various industries to which the rules will apply, including the private equity industry, in drafting the final rules, to ensure that the rules achieve their purpose in an effective, efficient manner.

Asset Calculation. Noting the peculiarities of GAAP accounting as applied to private equity firms, as described above, and the resultant potential for asset magnitude to be misrepresented and for similarly situated advisers to receive disparate treatment, commenters stressed the need for the final rules to calculate total consolidated assets in a manner that excludes assets under management. Commenters also urged the SEC to exclude goodwill, other intangible assets and deferred compensation from the calculation of "total consolidated assets," and to provide that the threshold amounts be indexed for inflation.

"Covered Financial Institution" Definition. There were many requests for those investment advisers not required to register under the Investment Advisers Act of 1940 to be excluded from the scope of the rules coverage, because either their activities do not rise to the level to justify direct federal supervision, or they are already governed by another regulator. Commenters specifically called for clear exemption of non-U.S. investment advisers that are not subject to registration from the rules' coverage, due to

¹⁹ *Id.*

²⁰ *Id.* at 21,276.

²¹ *Id.* at 21,178.

²² *Id.* at 21,181.

²³ See *Comments on Proposed Rule: Incentive-Based Compensation Arrangements*, *supra* note 6.

concerns about jurisdictional overlap.

Specific Characteristics of Private Equity Compensation. Additional comments included that (1) since carried interest already pays out based on actual, long-term performance (*i.e.*, it is calculated based on actual realizations), carried interest should be excluded from the definition of “incentive-based compensation,” and (2) since annual bonuses to private equity professionals are primarily paid out of bonus pools generally based on fixed management fees that do not vary with the level of risk taken, mandatory deferral of annual bonuses should not apply to private equity firms.

Other frequently made comments, applicable to all types of regulated entities, included suggestions to: exclude pre-existing compensation contracts from the rules’ coverage; clarify how the rules will apply to affiliated entities; include competition for talent as a factor to consider in evaluating whether compensation is excessive; clarify the definitions for incentive-based compensation and annual incentive-based compensation; provide guidance as to what would be considered an inappropriate risk; and revise the rules to be in the form of guidelines rather than rules.

What’s Next?

While the ultimate outcome is uncertain, several factors noted in the public comments may result in the modification of the final rules or clarification of their application to private equity firms. First, because private equity firms negotiate their funds’ carried interest and management fee arrangements with sophisticated third-party investors, there is a market check on excessive compensation. Second, private equity firms and funds do not raise systemic risk concerns. Third, the compensation arrangements at private equity firms and funds do not present the perceived problem that motivated much of this rulemaking, namely financial institutions taking long-term risks but being compensated currently with no adjustment if the risk fails to pay off in the long run. Private equity is different, because private equity professionals receive the bulk of their income earnings in the form of carried interest distributions, consisting primarily of a share of the realized gain from the sale of long-term investments.

Final rules are expected to be adopted by the various agencies in the first half of 2012. The final rules applicable to IAs are scheduled to become effective six months after they are adopted by the SEC in final form and published in the Federal Register.