Sam Haylen, Vicky Bird, Tessa Lubrun and Andrew Blair
Department of Work and Pensions

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

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Dear all

Re: Incorporating performance fees within the charge cap

We are writing on behalf of the British Private Equity and Venture Capital Association ("BVCA"), which is the industry body and public policy advocate for the private equity and venture capital industry in the UK. With a membership of over 700 firms, we represent the vast majority of all UK based private equity and venture capital ("PE/VC") firms, as well as their professional advisers and investors. Between 2015 and 2019, BVCA members invested over £43bn into nearly 3,230 UK businesses, in sectors across the UK economy ranging from heavy infrastructure to emerging technology. Companies backed by private equity and venture capital currently employ 972,000 people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses. From an investor perspective, when comparing the performance of the UK PE/VC industry with public markets, the five-year and ten-year annual returns were 20.1% and 14.2% respectively, compared to the FTSE All-Share, which returned 7.5% and 8.1% to investors over the same respective time periods.[1]

Overview

There is a growing body of research and analysis demonstrating that allocations to PE/VC offer powerful potential for improving the retirement outcomes of DC scheme members, which we refer to below and in our previous responses to DWP consultations looking at the charge cap[2]. We welcome the Government's recognition of this and support DWP's efforts to enable DC schemes to join other institutional investors in gaining exposure to the strong risk-adjusted returns that this asset class can deliver. The proposed smoothing mechanism and the suggested removal of look-through in relation to carried interest arrangements and performance fees in the context of venture capital and growth equity ("VC/GE") funds of funds are both positive steps, and we set out our thoughts and suggestions on these in response to the consultation questions below.

However, neither proposal will place DC schemes on a level playing field with other institutional investors because DC trustees' freedom to make allocations solely on the basis of improving outcomes for scheme members will remain restricted by regulations that make it difficult for them to construct balanced portfolios containing an appropriate mix of illiquid assets. DC trustees' hands will only be untied in this regard when performance fees and payments resulting from appropriately designed carried interest arrangements are rightly excluded from the charge cap calculation altogether. This will support trustees in moving away from a narrower cost paradigm and allow them to focus more sharply on member outcomes.[3]

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[1] For further comparative data see the BVCA Performance Measurement Survey 2019.
[2] See in particular our response to DWP's consultation "Review of the default fund charge cap" (pages 3 & 4).
[3] Please see our responses to DWP's consultations on Improving outcomes and Investment Innovation and Future Consolidation for detailed explanations of how inclusion of carried interest arrangements meet the

In summary, our key comments and recommendations are as follows:

1. The Government's aim of improving outcomes for DC scheme members by allowing them to invest in PE/VC and other illiquid assets will only be acheived if carried interest arrangements and performance fees are excluded from the charge cap calculation methodology altogether.

2. The smoothing mechanism, especially if extended to ten years and accompanied by protections for trustees against inadvertent breaches, would be a positive step in the absence of a more complete solution.

3. Abandoning the look-through approach in relation to fund of funds investments in illiquid assets (not just venture capital and growth equity) would also be a positive step, again in the absence of a more complete solution.

4. However, neither of the two amendments to the charge cap calculation methodology that the consultation envisages is likely to increase DC investment into PE/VC funds significantly.

5. An even more effective solution would be to disapply the charge cap entirely from costs and charges embedded in a financial product (as opposed to the transaction costs incurred in acquiring it).

Responses to consultation questions

Question 1: Are the performance fee regulations a) clear, b) likely to be taken up by trustees, c) going to make a difference to trustees' confidence to invest in illiquids?

- As set out in our response to DWP's 'improving outcomes' consultation[4], we broadly support the rationale behind this measure, which may allow some flattening out of carried interest or performance fee payments for the purposes of the charge cap calculation, thereby providing some protection against year-on-year variations. It may also allow DC schemes to foresee potential breaches of the cap and take appropriate action to avoid a breach, provided there is sufficient liquidity in fund interests, either within the scheme or on the secondary market (although in practice trustees may find it difficult to predict when outsized returns may occur on an ongoing basis, so this should not be seen as a reliable safeguard).

- However, we continue to believe that DWP should consider the following additional suggestions, which we believe could further increase trustees' confidence to invest in PE/VC:
    - A ten-year timescale would better reflect varying PE/VC holding periods, and lead to more accurate assessments of ongoing performance.
    - DWP should consider what objective framework might help trustees, when considering a particular fund investment opportunity, to assess the likelihood of a charge cap breach flowing from their investing in that fund or fund of funds.

policy objectives of the charge cap and how the inclusion of related payments in the charge cap calcuation creates a barrier to investment in PE/VC funds.

[4] BVCA response to DWP consultation "Improving outcomes for members of DC pension schemes".

  - Appropriate protection should be given to trustees against any liability for any inadvertent breaches caused by carried interest e.g. an ability to explain or cure any such breaches within a reasonable timeframe (12-18 months, as exists in the Israeli system), subject to appropriate conditions.

- Notwithstanding the above, we would like to reiterate that the impact of the relaxation to the charge cap calculation methodology that the smoothing mechanism offers is likely to be relatively limited, for two key reasons:

  - As confirmed by recent research from Mallowstreet in partnership with Partners Group, intense market pressure to offer 'low cost' pensions will continue to encourage many DC trustees to avoid allocations that feature carried interest arrangements or performance fees.[5] This supports our view that, as long as carried interest and performance fee payments remain subject to the charge cap, ongoing commercial cost pressure will discourage many trustees from selecting investments that would require them to allocate otherwise unused 'headroom' to such payments, despite the new flexibility provided by the smoothing mechanism.

  - The smoothing mechanism will also not completely remove the risk of charge cap breaches. We believe that this risk will incentivise DC schemes either to avoid investments using carried interest arrangements or performance fees entirely, or to select managers promising lower returns (against the long-term interests of scheme beneficiaries).

<u>Question 2: What is the likely appetite that pension scheme trustees have for investment in venture capital and/or growth equity?</u>

- In our view, the strong investment rationale for allocating to PE/VC funds (of which venture capital and growth equity funds are a subset); the fact that pension fund investors around the world act in large numbers on this rationale; and clear evidence that DC market participants recognise its potential, together point towards the existence of latent appetite amongst DC trustees for investment in PE/VC funds that is currently supressed by barriers such as the inclusion of carried interest payments and performance fees in the charge cap calculation.

- It stands to reason that the appetite for investment in PE/VC funds amongst DC pension scheme trustees would be strong, were it not for such barriers, amongst other reasons because the asset class is popular with investors around the world that are not subject to a charge cap (e.g. North American DB schemes).[6]

- Reasons for this popularity include that PE/VC fund investments can offer:

  - <u>Risk-adjusted returns</u> that, market-wide, have historically been favourable relative to public market averages.

  - <u>Access to private markets</u>, which are growing and offer exposure to fast-growing unlisted companies.

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[5] Mallowstreet DC Diversification Report, in partnership with Partners Group.

[6] A range of academic and industry evidence demonstrating the global popularity and performance of PE/VC fund investments is set out in our response to DWP's consultation "Review of the default fund charge cap".

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- A long-term investment opportunity for investors with long term horizons, such as pension savers. (This is particularly relevant because DC scheme members are increasingly encouraged to invest through multi-asset default fund arrangements (rather than self-select). These arrangements have an inherently long-term view and are professionally managed, effectively mirroring how DB schemes have been organised historically. The long-term nature of PE/VC fund investments means they are extremely well-suited to play a role in this long-term, multi-asset approach.)

- There is also a strong case that allocating to PE/VC would improve outcomes for DC scheme members specifically. Detailed modelling for a U.S. study suggests that by changing an asset allocation mix for a target date fund to include between 5 and 7% of private equity over a 45 year period, a DC scheme member contributing just over six thousand dollars a year to the target date fund could potentially increase the total amount saved and distributable in year 45 by approximately 8.7%, whilst not increasing risk.

- This positive analysis is mirrored by the positive perspectives of DC market participants on the potential of PE/VC to improve returns. The Mallowstreet and Partners Group research mentioned above, for example, found widespread belief amongst DC schemes and consultants that private assets can outperform listed equities over the long term by 1% to 3% p.a., with even higher expectations amongst larger schemes and master trusts. The same research suggested that trustees believe PE/VC can also bring diversification benefits and that schemes would be prepared to hold private markets assets for long periods of time (four to five years for smaller DC schemes, much longer for most). This suggests that demand would exist, were it not for perceptions that PE/VC is 'expensive', with high investment costs seen as a barrier by over half the DC schemes and consultants covered by the research.

- BVCA data on general PE/VC fund performance comparing the performance of the UK PE/VC industry with public markets demonstrate that the five-year and ten-year annual returns of funds managed by BVCA member firms were 20.1% and 14.2% respectively, compared to the FTSE All-Share, which returned 7.5% and 8.1% to investors over the same respective time periods.

Question 3: How do you currently treat look-through when calculating the charges regime of the scheme?

- In our experience, the application of the guidance on look-through is currently uncertain enough, from a legal and practical perspective, to discourage trustees from attempting it. There is legal uncertainty because the concept of "look-through" appears nowhere in the Charges and Governance Regulations 2015 nor in the definition of "administration charge" in Schedule 18 to the Pensions Act 2014. In the legislation, "administration charge" means (so far as relevant) any income or capital gain arising from the investment of member's money. This does not include any costs or charges "below" the level of, or embedded in, scheme investments. It is unclear whether a court would support the current guidance.

- Guidance based on "general commercial or industrial purpose" of an undertaking is borrowed from European Securities and Markets Authority guidance on the perimeter of the AIFM Directive, which was itself confusing and similarly fraught with difficulty. There is no clear economic rationale why the following types of investment should be treated differently for the purposes of the charge cap:

  - an investment directly into a PE/VC fund featuring a carried interest arrangement;
  - an investment into a fund-of-funds (imposing inevitably an extra layer of fees) investing in such PE/VC funds;
  - an investment (for example by means of index tracking) into the ordinary shares of any number of NYSE-listed alternative asset management companies;
  - an investment into a UK FTSE-listed REIT.

  There will exist, within each of these asset types, performance fees, carried interest, or other forms of remuneration structured in a similar way. The current DWP guidance produces arbitrary results.

- Trustees are disincentivised from testing these uncertainties, and innovating, particularly in the context of investment into illiquid investments because: (a) the costs of professional advice are likely to be prohibitive and adversely affect the risk-adjusted return that the scheme would otherwise secure; (b) the trustees would be unable to reverse their position easily or at a reasonable cost; and (c) the guidance might change during the holding period.

Question 4: Does look-through act as a significant barrier to investment into investment vehicles that allocate to VC/GE?

- In our experience, the uncertainties summarised above operate as a significant barrier (albeit not the most significant one, see our answer to Question 5 below). We are concerned that other Government efforts to encourage long-term investment into productive finance will be stymied by the current approach to the charge cap, whether or not the proposed revisions are carried through.

- The removal of the look-through approach would be a positive step towards allowing an element of PE/VC exposure into DC portfolios via funds of funds and similar structures, as it would prevent carried interest payments to underlying fund managers, and any performance fees (predominantly used in an open-ended context), from being taken into account in the charge cap calculations for fund of funds investments. This is appropriate because, in a fund of funds context, these payments are not made to the fund of funds manager, rather they are a profit allocation, akin to a cost, made before distributions are made to a fund of funds.

- Removing look-through would thus potentially make it easier than it currently is for DC schemes to invest in PE/VC funds via funds of funds and similar structures. This could directly benefit scheme members because PE/VC funds of funds offer both a means of reducing risk via broader diversification and an avenue for DC schemes over time to gather the expertise to invest directly in PE/VC funds themselves, should they choose to take that route. Pension funds around the world that have larger (e.g. 10-20%) allocations to PE/VC tend to be larger schemes, some of which have built up expertise over time even to invest directly into unlisted companies with high growth potential, or co-invest alongside PE/VC funds whose managers they know well. This approach can lead to better returns and lower overall fee burdens for investors that have the requisite scale.

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Question 5: Are there more significant barriers to the success of pooled illiquid investment vehicles than look-through? If so, what are they?

- Even if look-through were removed, the most significant barrier would remain - the inclusion in the charge cap calculation of carried interest payments relating to individual PE/VC funds.

- Commitments to PE/VC funds of funds themselves also typically apply management fees and use carried interest arrangements, to account for the long-term value-add that their managers deliver, and these remain subject to the charge cap. Fees and charges for PE/VC funds of funds are lower than for direct fund investments, largely because a fund of funds manager has no ownership responsibilities in respect of underlying portfolio companies. They are thus less likely to cause charge cap breaches if considered in isolation, but the risk would remain.

- Even without look-through, PE/VC funds of funds, when viewed through the charge cap lens, would remain 'expensive', with their higher returns obscured by the charge cap's focus on cost, whilst the higher risk/return profile of direct fund investments would remain out of reach. As we noted in our answer to Question 1 above, there is intense market pressure to offer 'low cost' pensions, which will continue to encourage many DC trustees to avoid allocations featuring any carried interest arrangements at all, including attached to fund of fund commitments.

- A more effective and complete solution would be to remove carried interest payments from the charge cap calculation altogether. As highlighted in previous BVCA responses, carried interest is a profit share that we believe is more akin to a management-incentivising share option than a traditional performance fee and should on principle be excluded from the charge cap calculcation (which should focus on transaction costs). The retention of carried interest as part of the charge cap calculation also creates a perverse incentive for trustees applying the smoothing mechanism to select direct investments in funds on the basis of how likely they are to be only moderately successful. We therefore continue to believe that carried interest should be excluded from the charge cap calculation.

- A still more effective and complete solution would be to disapply the charge cap entirely from costs and charges embedded in a financial product (as opposed to the transaction costs incurred in acquiring it), which would allow DC schemes to invest in a broad range of illiquid assets that employ either carried interest payments or NAV-based performance fees. Irrespective of the charge cap, trustees already owe fiduciary and statutory duties to have regard to underlying investment costs when making an investment. They should be encouraged to make investment decisions based on the optimum risk-adjusted returns they are able to secure for members, without being restricted by an inflexible rules-based framework.

Question 6: If perceived as a significant barrier, how can the Government act to ensure it is removed whilst maintaining member protection/the objectives of the charge cap? Should this change be a regulatory one or in guidance?

- From a purely PE/VC perspective, the look-through approach could be removed whilst maintaining DC scheme members' protection and the policy objectives of the charge cap.

- This is because carried interest arrangements are an inherently effective method of protecting investors that is consistent with the policy objective of the charge cap (which the BVCA fully

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supports). PE/VC fund managers are typically only entitled to carried interest payments once they have returned investors' (in this case, DC scheme members') capital plus a preferred return (often around 6-8%). This aligns investors' long-term interests with those of PE/VC fund managers and leaves little scope for fund managers to profit in the event of poor or merely short-term performance.[7]

- The charge cap should support the policy objective of protecting scheme members against schemes being overcharged directly by funds of funds. This protection would remain if look-through were removed.

- DC schemes could be encouraged to replicate the approach taken by many DB schemes, where an allocation limit is used to limit liquidity and concentration risk. These are arguably more important considerations for DC trustees wishing to protect their members than global industry standard fees and profit share structures like carried interest.

- As a board member of the FCA-sponsored Cost Transparency Initiative (hosted by the PLSA)[8], the BVCA is also a strong advocate for transparency of reporting around costs and charges generally and was instrumental in the creation of the CTI's private markets reporting template. Carried interest arrangements / profit allocations relating to direct of fund of funds investments should be included in this kind of financial reporting to investors, rather than factored into the charge cap calculation.

- We feel trustees would be more confident to invest in PE/VC if any changes to the look-through approach were given a more secure legal footing in the regulations, rather than being made via guidance.

Question 7: Is there a risk of arbitrage? How can this be mitigated?

- Institutional investors choose PE/VC fund of funds managers because they can offer an attractive investment proposition to those looking for greater diversification and a lower risk profile, and because they wish to harness those managers' expertise in selecting and investing in[9] the most promising underlying PE/VC funds. The establishment of fund of funds structures *purely* for arbitrage purposes would be limited to an extent by the significant extra cost associated with running these structures, and also because by definition the vehicle would have to employ a fund of funds strategy, thereby bringing diversification and risk benefits for investors, alongside potentially easier compatibility with the charge cap.

- The potential for investment opportunities to be inappropriately categorised as VC/GE investments, purely to help a DC scheme navigate the charge cap, depends to an extent on whether the rules provide a tight but effective definition (see our response to Question 8, below).

- In any event, we strongly believe that a level playing field between asset classes is important, because DC trustees should be free to make allocation decisions on the basis of economic considerations and scheme members' long-term best interests, rather than on the basis of

[7] For further information on how carried interest arrangements work in investors' interests, please see the BVCA [response](#) to DWP consultation "Improving outcomes for members of DC pension schemes".
[8] https://www.fca.org.uk/news/statements/fca-statement-launch-cost-transparency-initiative-cti
[9] The 'execution' of an investment in a PE/VC fund requires significant legal and other advisory work and often involves a relatively lengthy process of detailed negotiation between investor and manager.

regulatory considerations. Different illiquid assets have different characteristics and serve different purposes within a balanced portfolio. Different schemes may judge members' interests best served by different levels of exposure to venture capital, growth equity, mid-market or large cap private equity buy out, infrastructure, private credit and/or a mix of different types of real estate and other illiquid assets. In relation to each of these, returns are likely to be driven by various carried interest arrangements or performance fees. Removing look-through for funds of funds investing in merely some of these asset classes would likely skew DC portfolios in the direction of those asset classes for regulatory reasons above economic ones, thus creating a conflict between charge cap compliance and the optimisation of member outcomes.

Question 8: Are there recognised industry definitions of venture capital and growth equity?

- As detailed in our response to Question 7, we believe that changes to the charge cap calculation should not artificially incentivise DC investment into one private markets asset class over another, via funds of funds or otherwise.

- There are potential starting points that already exist, were DWP to attempt this, such as the FCA Handbook glossary definition of *venture capital investment*[10], which offers a reasonably accurate and useful definition. Another option might be to focus on specific attributes of an investment strategy that meet the policy objective (e.g. a long-term capital growth strategy, restricted predominantly to investments in unlisted businesses or assets).

- However, in our view any risk of arbitrage would be much more effectively eliminated if look-through were instead removed in relation funds of funds investing in the full range of private markets or illiquid assets. One approach here might be to mirror the list of eligible assets for any Long Term Asset Fund (LTAF) vehicle, or any similarly broad definition of assets that are currently considered too 'expensive' as a result of the inclusion of carried interest arrangements and performance fees within the charge cap calculation. This would remain a less effective and complete solution than removing carried interest payments and performance fees from the charge cap calculation altogether.

Question 9: Are there any other proposals that the Government should consider to allow greater investment in venture capital or growth equity?

- The inclusion of carried interest and performance fees in the charge cap calculation is the key barrier, both in itself, and as a foundation of the current approach of prioritising costs over value (because it encourages DC schemes to compete on costs at the expense of potentially higher returns). Instead of including them in the charge cap calculation, trustees should be directed to require PE/VC fund managers to report carried interest payments and performance fees alongside risk-adjusted net returns (as they already do under the Cost Transparency Initiative and other investor reporting frameworks).

- We also encourage the Government to consider in detail the recommendations of the Bank of England and the FCA's Productive Finance Working Group, of which the BVCA is a member, when these are made later this year. We believe that intermediate structures, potentially using the proposed LTAF vehicle, may well be required to reconcile the illiquidity of underlying PE/VC funds with DC schemes' need for ongoing liquidity by offering appropriate liquidity

[10] See the FCA Handbook definitions of venture capital investment and venture capital business.

mechanisms and pricing information, as well as other features of private markets and authorised funds that have hitherto seemed incompatible.

- Any such LTAF or other vehicle would likely need to be seeded with sufficient initial assets to mitigate the fact that PE/VC investments involve an initial capital outlay followed by increasing returns during the later years of a fund's life (the 'J-curve'). Key to eliminating any J-curve risk is to allow LTAFs to make 'secondary' purchases of other investors' interests in established funds that have begun investing in portfolio companies and making distributions to investors. These secondary purchases will provide visibility around early cashflow returns and allow managers to prevent a J-curve arising at the level of the intermediate vehicle.

We would be very keen to discuss the contents of this letter with you and look forward to hearing from you in order to establish whether a meeting of this sort is possible.

Yours sincerely,

Tim Lewis
Chair, BVCA Regulatory Committee