David Eaton
Department for Work and Pensions
DC Policy Team, Policy Group
Private Pensions and Arms Lengths Bodies Directorate

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

30 October 2020

Dear Mr Eaton,

Re: BVCA response to DWP Consultation Paper on Improving outcomes for members of defined contribution pension schemes (the "Consultation Paper")

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. With a membership of over 700 firms, the BVCA represents the vast majority of all UK based PE/VC firms, as well as their professional investors and advisers. BVCA members invested over £43bn into nearly 3,230 UK businesses in the period 2015-19, the majority being SMEs, and companies backed by PE/VC currently employ around 972,000 people in the UK. 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]

Why this Consultation Paper is important to BVCA members

We applaud the DWP's objectives of encouraging consolidation amongst DC pension schemes and facilitating DC access to long term, high performing illiquid assets. These proposals represent an opportunity for the Government to improve retirement prospects for millions of UK pension savers by taking steps to level the playing field with other institutional investors, which are already able to improve the returns they achieve for their beneficiaries by building balanced, resilient portfolios with a broad range of assets, including illiquid strategies. Indeed, it is currently easier for members of most overseas pension schemes to invest in UK private equity and venture capital funds, which offer different risk-return profiles and have consistently outperformed public equities[2], than it is for members of UK DC pension schemes.[3]

Should effective changes be made to the charge cap calculation, our expectation is that larger firms and those managing funds of funds, in particular, will seek to offer illiquid assets to DC schemes. These firms are typically more likely already to have the platform expertise and operational ability to help DC schemes clear the regulatory and operational hurdles that exist. An issue currently is that having cleared the hurdles, DC schemes run into an insurmountable barrier in the form of the charge cap. We therefore welcome the opportunity to respond to this Consultation Paper's efforts to transform the charge cap from a barrier preventing DC schemes from investing in funds managed

[1] For further comparative data see the BVCA Performance Measurement Survey 2019.
[2] See extensive research evidence provided in our response to DWP's August 2020 consultation on the review of the default fund charge cap and standardise cost disclosure.
[3] Less than 5% of UK-raised funds managed by BVCA members comes from UK pension funds (of which nearly all comes from defined benefit plans).

by our members, to a hurdle that certain BVCA member firms will seek to help DC schemes overcome.

Overall comments and key points

We have consistently argued that, although it is an effective and important protection in respect of products that charge up-front fees based on AUM, the default scheme charge cap does not accommodate effective, long-term incentive models such as carried interest (which drives both PE/VC fund investors' returns and the growth trajectory of fund portfolio companies).

Although carried interest is only knowable in retrospect and in theory is unlimited, it also carries an inherent protection against any manager incentives eroding beneficiaries' capital or returns, because it is only earned after investments have performed well enough for investors to have already recouped the cost of their investments plus a preferred return. We refer to our previous DWP consultation responses for further detail on this.[4] A breach of the charge cap due to carried interest payments would therefore seem to be a positive outcome for a DC beneficiary, because it would necessarily be accompanied by high returns for the saver (and we also applaud DWP's acknowledgement in the Consultation Paper of the importance of trustees focussing on returns, as well as costs).

Whilst it may be possible to structure DC portfolios in ways that reduce the likelihood of carried-interest driven breaches of the charge cap, the theoretical risk is impossible to eliminate and therefore is likely to remain a significant concern for DC trustees. We continue to stress that carried interest is better characterised as a profit share, rather than a performance fee, and that the best way of helping to improve outcomes for DC scheme members in this context would be for DWP to exclude it from the charge cap calculation (subject to appropriate conditions). However, we believe that this Consultation Paper suggests some broadly positive steps and have set out our comments and further suggestions below, in the hope of providing constructive feedback to assist DWP in designing effective changes to the current rules.

Responses to consultation questions

We have responded only to the questions most relevant to PE/VC fund managers.

Question 1: We would welcome your views on the reporting of net returns – how many past years of net returns figures should be taken into consideration and reported on to give an effective indication of past fund performance?

We support DWP in exploring structures and mechanisms that encourage DC schemes to focus on overall net returns when investing in illiquid, long term assets.

PE/VC funds are typically closed ended investment vehicles, due to the illiquid nature of interests in unlisted portfolio companies. A complete understanding of a particular closed-ended PE/VC fund's performance can only be gained by measuring it at the end of the fund's life, when all the fund's investments have been realised (just as the performance of an individual investment in a particular portfolio company can only be measured once the fund has divested its interest in that company). PE/VC funds typically have a pre-agreed term of 10-12 years, but this is often extended in agreement with investors. Different strategies also tend towards different terms, for example it is common for venture capital funds to have a term of 15 years or longer agreed at the outset in an

[4] DWP review of the default fund charge cap and cost disclosures; investment innovation and future consolidation

attempt to avoid the need to sell stakes before the relevant companies have had chance to reach their potential.

Given the wide diversity in portfolio company holding period and duration of fund life, it is difficult to see how a timeframe shorter than the life of each investment in a portfolio company or each fund's life would fully and accurately assess past performance in all cases. However, a practical compromise solution may be necessary and achievable, in which case we believe that a timescale of 10 years for considering and reporting on the performance of PE/VC funds would be appropriate. This would reflect portfolio company holding periods and the time it takes for most of a PE/VC fund's portfolio companies' business plans to mature into value for investors.

Question 4: Do the draft regulations achieve the policy intent of providing an easement from the prorating requirement for performance fees which are calculated each time the value of the asset is calculated?

We broadly support this proposal, as it could help remove the challenges related to treating partial year members fairly. However, it may not completely solve the fundamental mismatch between DC schemes' requirement for daily valuations and the reality that PE/VC assets are difficult to value more frequently than quarterly, and that an estimate of the amount of carried interest based on NAV may differ from the ultimately realised total.

Question 5: What should we consider to ensure a multi-year approach to calculating performance fees works in practice?

DWP may wish to consider the impact that the accounting treatment of PE/VC funds' carried interest escrow and clawback arrangements may have on the proposed mechanism. These arrangements are commonly agreed as a means of ensuring that any payments of carried interest during a PE/VC fund's life do not distort the agreed profit share proportion between manager and investors, looking at the whole fund's overall performance during its lifetime.[5] Carried interest entitlements may accrue on the basis of NAV valuations before being paid in cash that 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. For the purposes of a multi-year smoothing mechanism, we suggest that the relevant performance fee element should be the amount of carried interest paid in cash into escrow, but suggest that DWP consider and clarify this.

Another feature of PE/VC funds that DC scheme trustees assessing performance fees using a multi-year approach may need to take into consideration is the typical reduction in management fees at the end of a fund's investment period (usually around five years into the life of a fund). At this point, the basis on which management fees are charged shifts from committed capital to invested and unrealised capital, to reflect that the manager's role no longer involves finding and executing new investments. Although this is not directly related to the performance fee element of the charge cap calculation, the progressive decline in management fees after a fund's investment period will presumably affect any 'headroom' below the cap.

We also believe that intermediate structures will be required to reconcile the illiquidity of underlying PE/VC funds with DC schemes' need for ongoing liquidity. This may involve master trust vehicles that can offer daily pricing information so trustees can ensure the cap is respected,

[5] For further detail, see the appendix to our response to DWP's 2019 consultation on [Investment Innovation and Future Consolidation](#).

although this approach may require intermediate vehicles 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'). We would be happy to discuss this further with DWP.

DC trustees would also likely benefit from a framework for objectively assessing, at the time a scheme investment in a PE/VC product is proposed, whether making that investment is sufficiently unlikely to cause the scheme to breach the charge cap. We suggest that DWP consider what benchmarks, historical returns or other bases might be appropriate for this, potentially taking into account any diversity of fund performance across different managers and investment strategies.

Question 6: We are proposing a five-year rolling period. Is this appropriate or would another duration be more helpful?

We broadly support the rationale behind this measure, as it may allow some flattening out of performance fee payments for the purposes of the charge cap calculation, thereby providing some protection against year-on-year variations; and it may 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 feel that a period of up to 10 years would provide a more appropriate timescale for DC schemes to measure performance accurately and allocate an appropriate performance fee element to the charge cap calculation. Any timescale applied at the asset level would need to reflect average portfolio company holding periods and allow time for business plans to mature into investor returns. Similar underlying considerations apply at a product/fund level, where the most accurate approach for a closed ended fund would be to judge performance at the end of the fund's life, once its performance is known. Nevertheless, ten years would be better than five years for reflecting the performance of a portfolio of companies with varying holding periods.

Question 7: We are proposing offering a multi-year option as an alternative to an in-year option for schemes. Do you have any suggestions for how to improve this offer?

Question 8: To what extent will providing a multi-year smoothing option give DC trustees more confidence to invest in less liquid assets such as venture capital?

DC trustees' may lack the confidence to invest in PE/VC funds because the amount of carried interest payments, which cannot be accurately predicted, may end up greater than the amount of 'headroom' available across the portfolio on a blended basis. A typical institutional investor might allocate 5-15% of its capital to PE/VC funds. Based on average historical returns, we believe that DC schemes investing similar proportions in PE/VC funds might often have insufficient headroom and would breach the charge cap even if they used the proposed multi-year accrual method. The lower the proportion of the portfolio allocated to PE/VC funds, the less likely a breach, and it may be possible for DC schemes to feel comfortable that a smaller allocation of, for example, 1/2%, posed sufficiently low risk of a breach. However, the theoretical risk will remain, particularly where funds ultimately achieve top quartile performance.

Given that strong performance and realised returns seem to be prerequisite to any breach of the charge cap resulting from carried interest payments, we feel DWP should consider giving DC trustees appropriate protection against any liability for any inadvertent breaches caused by performance fees or carried interest (accrued or paid). This could take the form of an ability to explain or cure any such breaches within a reasonable timeframe (12-18 months, as exists in the Israeli system) and any exclusion of liability should be subject to appropriate conditions, relating, for example, to the reasons why excess returns have been generated or the proportions in which any profit share is allocated (for PE/VC funds this is typically 20:80 in favour of investors). Protections for trustees would help eliminate any liability for DC schemes that breach the charge cap because their investments have performed too well, and could provide further comfort that investing in the more successful PE/VC funds would not have negative consequences for DC trustees.

We note that market pressure on fees would remain a potential disincentive, but are hopeful that an increased focus on net returns might assist in countering this.

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

Yours sincerely,

Tim Lews
Chair, BVCA Regulatory Committee