Guy Opperman MP
Minister for Pensions and Financial Inclusion

Andrew Blair, Des Healy
Department for Work and Pensions

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

18 January 2022

Dear Guy, Andrew, Des

Re: Enabling investment in productive finance

We are writing on behalf of the British Private Equity and Venture Capital Association, the industry body and public policy advocate for the UK private equity and venture capital (PE/VC) industry.[1]

We are extremely grateful for DWP's engagement, with ourselves and industry more broadly, on addressing the barriers to DC schemes' investment in productive finance assets, including PE/VC funds and the portfolios of unlisted companies to which they provide access. We welcome the opportunity to respond to this consultation and have set out our thoughts on DWP's proposals in this letter and its appendices. We hope you find our comments useful in taking this policy forward, and would be delighted to discuss any of our suggestions or provide further feedback in person.

Freedom of choice will spur innovation, for the benefit of UK DC savers

We believe there is an urgent need to facilitate investment by UK DC schemes in illiquid assets, including UK PE/VC funds, in order to improve the retirement outcomes of UK pension savers (as they will gain access to high returning asset classes) and encourage the flow of capital into innovative UK businesses. The charge cap's current inclusion of performance fees and carried interest is a gating item and key regulatory barrier to achieving this.

Removing this gating item/barrier will incentivise PE/VC fund managers and DC schemes to come together, with the help of advisers and other market participants, to overcome the various other market and operational hurdles identified in forums such as the Productive Finance Working Group. We set out our recommendations on how this might best be achieved in our answer to Q3, and would warmly welcome the opportunity to discuss the options further with DWP.

Furthermore, we do not believe that making this change will expose DC beneficiaries to inappropriate financial risks. Global institutional investors have long required fund managers to include performance-based incentive mechanisms in illiquid asset fund terms, especially those focussed on ambitious long-

[1] With a membership of over 700 firms, the BVCA represents the vast majority of all UK based private equity and venture capital firms, as well as their professional advisers and investors. Between 2016 and 2020, BVCA members invested over £47bn into around 3,500 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 1.1m people in the UK and the majority of the businesses our members invest in are small and medium-sized businesses.

term growth targets, to support the alignment of fund managers' interests with the long-term financial success of portfolio companies and investors. The UK/European carried interest model achieves this, as a profit share that is only paid on realised gains when a fund as a whole has made a profit above a certain rate. It thus presents no risk of eroding pension savers' retirement pots because carried interest payments are *only* made once those pots are already growing as a result of the fund manager's sustained efforts to deliver strong returns to investors.

Any existing or innovative performance fee mechanisms that might be required to help DC schemes address liquidity or other operational challenges whilst investing in illiquid assets (including for example via the LTAF) will follow similar principles of alignment, whereby managers are only entitled to performance-related payments where strong performance is achieved (i.e. net returns are increased above a pre-agreed hurdle). This is the standard global approach for illiquid assets with long hold periods where value creation is fuelled by significant ongoing involvement of the fund manger in the success of the fund's assets.

Nor do we believe the proposed change will lead to PE/VC firms or other market participants extracting predatory charges from DC schemes. This is because of strict regulation and powerful market forces on both sides of this equation, high disclosure standards and the increasing familiarity of DC trustees with this asset class that the proposed change will bring. The BVCA fully supports transparency from its members on the issue of costs and charges reporting, and has given its full support to reporting initiatives such as the FCA-sponsored Cost Transparency Initiative.

In our view, the outcome of DWP's proposal will also reinforce the need to focus on overall returns as well as investment costs, and signal to trustees that the returns and diversification benefits of long-term illiquid assets make them suitable candidates for inclusion in UK pension savers' retirement plans. DWP's proposal will thus motivate both PE/VC fund managers and DC schemes to seek commercial arrangements that will improve the retirement prospects of the UK's DC pension savers, as well as the fundraising prospects of its entrepreneurs.

We would be happy to discuss the contents of this letter with you; please contact Tim Lewis (tim.lewis@traverssmith.com) and Tom Taylor (ttaylor@bvca.co.uk).

Yours sincerely,

Tim Lewis, Chair, BVCA Regulatory Committee

APPENDIX I: Headline BVCA comments

BVCA perspective on the case for change

The latest research suggests an urgent need to facilitate UK DC schemes' access to UK PE/VC funds

The economic case for a policy change facilitating investment by DC schemes into PE/VC funds, in terms of overall returns and diversification, was highlighted by the Productive Finance Working Group, whose report stated that "a wide range of literature illustrates how less liquid assets can outperform their more liquid, often listed, counterparts." Since the publication of the PFWG report, the BVCA has conducted further analysis of our members' historic returns, updating the data to include an additional year of returns and focussing specifically on comparing the PE/VC fund industry returns with public markets using two public market equivalent methodologies. The results of this research robustly confirm the conclusions of earlier research conducted by various academics and data providers, and demonstrate that the industry as a whole has consistently delivered higher returns to investors than the FTSE All Share Total Return index, from 1991 onwards. This underscores that DC schemes urgently need to find ways to access illiquid assets, particularly the innovative, unlisted companies that PE/VC funds seek out because they promise growth and generate strong returns.

UK DC schemes should have the same investment opportunities as their international peers

A broad range of international investors currently benefits from the returns delivered by UK PE/VC firms, with around 40% of the total funds raised by BVCA members coming from US, Canadian, Asian and other pension funds (in a typical year). Amongst those investors who are able to, many nevertheless choose not to invest in PE/VC funds for a variety of reasons, just as some DC schemes will also choose not to invest. However, we welcome the DWP's current proposal because it will deliver freedom of choice, from a regulatory perspective, for those UK DC schemes that *are* interested in PE/VC funds, to decide whether to allocate to them or not. This will put DC schemes on a level-playing field, from a regulatory perspective, with many of their global peers. It will allow everyday UK default pension savers to benefit, where trustees deem appropriate and once any operational hurdles are cleared, from the market-beating returns and diversification benefits that US, Canadian, Asian and other pension savers are already enjoying as a result of investing in the UK's PE/VC fund industry.

The economic case draws on data relating to the historic performance of PE/VC funds

Carried interest and performance fees are integral to the success of long-term illiquid investment fund strategies. In some situations, some large and experienced investors may agree bespoke economic terms that do not include performance fees or carried interest, for example as part of a co-investment mandate. However, it is important to note that such arrangements are not typically included in the PE/VC fund performance statistics on which the case for DC investment into this asset class has largely been based. The returns and diversification benefits demonstrated by the various in-depth studies and analyses of the sector, many of which are referred to in the PFWG's report, are the returns and diversification benefits of typical PE/VC funds, with typical carried interest arrangements, not of investments via any such bespoke or more unusual arrangements (which are outside the scope, at least of BVCA performance data[2]).

This policy will spur the innovation required to enable DC schemes to tap into this performance

We are not aware of UK DC schemes currently investing in typical UK PE/VC funds alongside their peers from other jurisdictions (such as Australian DC schemes). We believe that removing well-designed performance fees and profit-share arrangements such as carried interest from the scope of the charge cap, whilst rightly leaving genuine investment costs subject to the cap is pre-requisite to changing this. DC schemes and PE/VC fund managers currently face a variety of hurdles in agreeing fund structures and terms that work for both parties, and have not managed to do so despite the industry having a strong track record of innovation. This is because neither DC schemes nor PE/VC fund managers currently have sufficient incentive to innovate around around those hurdles, due to concerns carried interest and performance fees will breach the charge cap when funds perform well. This is a regulatory barrier and the key 'gating item' to DC investment in PE/VC funds.

By contrast, removing performance fees and carried interest from the charge cap is likely to spur innovation because it will make the objective achievable from a regulatory perspective, where currently it is not (so managers and investors do not expend the necessary resource trying to solve the other, less instantly prohibitive issues). There are currently relatively small numbers of PE/VC fund managers and DC schemes attempting to innovate in this space within the confines of the charge cap, i.e. outside the typical PE/VC fund structure that uses carried interest arrangements. We believe firms like these are likely to be amongst the first to agree fund products, LTAFs or otherwise, that work for DC schemes once the charge cap rules are appropriately amended. It is impossible to predict precisely how markets will evolve, but we would expect other firms to follow when the concept is proven, particularly given consolidation and the growth trajectory of the DC market as a whole (which is predicted to double to £1tn by 2030). This will make the resources required to invest successfully in PE/VC funds more readily available to a wider pool of DC trustees.

<u>BVCA recommendations on how the change should be implemented</u>

Prescriptive conditions should be avoided in favour of a principles-based approach

We understand DWP's concerns that pension savers should be protected from predatory charges (which we consider in more detail in our answer to Q4), and share the Government's interest in avoiding this outcome.

However, it is essential that, whilst effectively protecting investors, DWP's rules also allow enough flexibility for DC schemes and illiquid investment managers, including PE/VC firms, to agree appropriate performance-based incentive arrangements to suit the specific circumstances of each proposed investment mandate. The rules must not tie managers and investors to prescriptive approaches embedded in legislation, and should instead draw on principles-based guidance that trustees can use as a lens to examine whether a particular structure offers effective alignment and value for money.

[2] The BVCA Performance Measurement Surveys exclude co-investments and only cover the returns of funds structured as a "typical limited partnership with a fixed, long-term fund life." See page 70 of our 2020 report for the survey's eligibility criteria.

We see a number of benefits in this approach. Firstly, there are too many commercial variables across different fund types and even the terms of similar structures will differ according to the commercial realities of specific situations. Secondly, innovation will be required to marry illiquid strategies with the characteristics of DC schemes, and innovation requires flexibility. And thirdly, an overly-prescriptive approach may create risks of its own, such as by opening opportunities for arbitrage or leaving ambiguity around whether a particular product falls within the rules. Please see our answer to Q3 (Appendix II) for further detail on why we support this approach.

Regulation, market forces and disclosure will preclude inappropriate fees

We are confident that a principles-based approach will not lead to PE/VC firms or other market participants extracting predatory charges from DC schemes. One reason for this is that PE/VC firms, which are FCA-regulated businesses, and DC trustees, who have fiduciary duties and are required to take appropriate advice, are both professional parties subject to high entry requirements and ongoing legal and regulatory obligations. The regulation and sophistication of both parties is a powerful safeguard against inappropriate, unbalanced agreements, as well as the foundation of the FCA's distinction between professional and retail investors. To build on this, DWP should focus on monitoring and supporting good governance amongst DC schemes.

Another reason is that PE/VC firms, and illiquid asset managers more broadly, operate in a highly competitive market environment. In this context, any proposals for egregious management fees or excessively generous performance-based incentive arrangements will be immediately obvious, commercially untenable and reputationally damaging for the manager. Fund managers cannot realistically dictate fee levels in isolation from the wider market.

Disclosure and reporting standards around fees and charges are also already very high, as a result of both regulation and industry initiatives. This should allay any concerns that removing performance fees and carried interest from the scope of the charge cap will dilute transparency (see our answer to Q4 for further detail on this). The BVCA supports full transparency from its members on this area[3].

The role of awareness-raising and guidance

The PFWG and others have identified a lack of familiarity with illiquid investment strategies amongst DC schemes, investment consultants and other market participants. We feel this is normal, as the DC market does not yet have widespread experience of investing in PE/VC funds, nor indeed of examining a range of PE/VC fund investment opportunities in great detail, because the constraints of the charge cap limits the number of serious proposals from managers. If these constraints are removed, the next step for many DC schemes, their advisers and investment consultants, will likely be to familiarise themselves with the range of illiquid investment fund models and strategies in the market. Much of this familiarisation will be achieved by DC schemes and their advisers holding direct conversations with PE/VC fund managers, themselves newly incentivised to engage in such discussions by the removal of the key gating item.

However, we believe there is also a role for industry associations in this familiarisation process. The BVCA is already contributing to the ongoing PFWG workstreams and liaising with other relevant trade

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[3] Further detail on the PE/VC industry's work on cost transparency and reporting to investors is available here.

associations on raising awareness amongst DC schemes, advisers and investment consultants on the topic of performance fees and carried interest. This is intended to cover what carried interest and performance fees are, why they are used in many private markets contexts, and how different models work by aligning fund managers' and investors' interests throughout the long hold periods required for PE/VC portfolio companies to mature and deliver strong returns. These industry efforts will only have a measurable impact on DC investment into illiquid assets if DWP's proposed policy is enacted i.e. it is clarified that carried interest and performance fees should not be considered as costs to be included in the charge cap calculation.

A key objective of awareness-raising will be to explain why carried interest and performance fee arrangements are welcomed across the PE/VC fund industry by large and sophisticated global investors. These investors see carried interest as one of a number of building blocks that together align the interests of fund managers and investors in PE/VC funds. This means DC trustees will need to consider the workings of a particular carried interest or performance fee structure not in isolation, rather holistically as part of a broader package of elements designed to ensure that fund managers are economically incentivised to sustain value creation activities over hold periods of several years and thereby maximise returns from each portfolio company investment. DC trustees will also need to place this alignment structure within the context of the manger's track record and the investment strategy, structure and net return profile of the fund. Some of these other elements of alignment and features of PE/VC fund products are explained in more detail in Appendix III. Industry awareness-raising, alongside the DWPs' proposed guidance on the features of well-designed performance fee structures, will support DC schemes in evaluating particular fund offerings from a holistic perspective.

APPENDIX II: BVCA responses to specific consultation questions

Question 1a: Would adding performance-based fees to the list of charges which are outside the scope of the charge cap increase your capacity and appetite, as a DC scheme, to invest in assets like private equity and venture capital? Are you already investing in assets like private equity and venture capital, and if so would this change increase how much you invest? If you do not currently invest in such assets would this change make it more likely for you to, and do you have an idea of to what % of AUM that might be?

Although the BVCA primarily represents PE/VC fund managers, our membership also includes around 120 investors in PE/VC funds. This section of our membership includes a number of UK pension funds, both DB and DC schemes. Based on feedback from some of these and other members, we believe that, although a few UK DC schemes may currently have some broader private markets exposures, they currently do not invest in the typical comingled, closed-ended PE/VC funds managed by BVCA member firms.

The BVCA's annual industry performance statistics (cited in the PFWG report) relate specifically to the historic returns delivered by typical, comingled, closed-ended PE/VC *funds* (which invariably feature performance fees or more likely carried interest). The BVCA statistics do not relate to other less mainstream or more bespoke arrangements like co-investments that fund managers may agree with particular investors (with or without carried interest). We do not collect data on returns from such arrangements and cannot confirm whether or not they have historically delivered returns comparable to those delivered by our members' PE/VC funds. Our point here is that they are a different type of investment to an investment in a PE/VC fund, with different risk/return profiles likely in each case.

It is clear that many DC schemes do not currently have the appetite to invest in PE/VC funds, be it because of a lack of familiarity with the asset class, insufficient scale, prohibitive operational challenges and/or market pressures. Others may have come to a balanced conclusion that PE/VC fund exposures are not for whatever reason appropriate for that scheme's particular circumstances. However, feedback from both manager and investor members of the BVCA strongly indicates that at least some of the larger DC schemes already have the appetite to invest in PE/VC funds but have concluded this is not currently possible due to the rules' characterisation of carried interest as a performance fee that falls within the scope of the charge cap. It seems clear that lack of capacity is holding back such schemes from investing in PE/VC funds, rather than lack of appetite.

We believe that trustees who already have the appetite to invest in PE/VC funds should be given the capacity to do so (subject to their fiduciary duties and having taken the necessary advice), and that removing performance fees and carried interest from the scope of the cap is pre-requisite to that. Some DC schemes that do not currently have the appetite to invest in PE/VC funds will not develop the appetite merely as a result of the proposed change. However, we expect that if the freedom to negotiate appropriate performance fees and carried interest is granted, increasing numbers of DC schemes will be motivated to explore the possibility, particularly as consolidation takes effect and the market doubles in size by 2030, as is widely predicted.

Question 1b: Would adding performance-based fees from the list of charges which are outside of the scope of the charge cap incentivise private equity and venture capital managers to change their fee structures?

A particular area where technical innovation may be required is around the design of performance fee structures for open-ended products that work for DC schemes. We welcomed the FCA's creation of the Long Term Asset Fund (LTAF) vehicle, and a variety of BVCA member firms have shown interest in launching LTAFs with DC schemes as investors. Subject to the resolution of some outstanding operational, tax and regulatory concerns, we expect the LTAF may offer a viable structuring option for certain arrangements.

However, the LTAF's authorised, open-ended nature, although perhaps well-suited for addressing DC schemes' inherent liquidity requirements, is perhaps less well-suited to the standard carried interest model that, whilst fundamental to the success of the global PE/VC industry, is designed for closed-ended funds. It may be that investors and managers will be able to design LTAFs (or indeed other open-ended vehicles) that accommodate DC schemes' liquidity needs whilst maintaining a more traditional carried interest model of alignment, but we think firms and prospective DC investors are also likely to want to explore different alignment models that may be more easily adapted to fit with DC schemes' liquidity and operational needs, such as NAV-based performance fees with high water mark provisions.

Innovation may also occur in relation to the balance between different elements of the PE/VC alignment model. It may be that schemes and managers conclude in individual cases that alignment can be achieved with lower management fees and a higher performance-based element (or vice versa), and/or a different level of PE/VC firm commitment, or a different hurdle rate, or the inclusion in the terms of the arrangement of some other commitments from the manager or investor e.g. co-investment rights or commitments to other funds. The mixture of commercial variables that makes up an investor's agreement(s) with a PE/VC fund manager has many ingredients. It is impossible to predict precisely what balance of these will work best in each case, and we believe it is likely that different schemes may come to different conclusions with different managers and different funds.

The important point is that carried interest and performance fees are a key part of the commercial mix in this context. Without them, it is difficult, if not impossible, for market participants to come to any arrangement that effectively aligns each party's interests and achieves enhanced returns targets over the long term. Removing them from the scope of the charge cap will give PE/VC firms, DC schemes, advisers, platforms and consultants greater reason and greater freedom to innovate collaboratively in designing such arrangements.

Whilst we agree with DWP's proposed direction, from a drafting perspective we are not convinced that simply adding performance fees (which would ideally be defined specifically to include carried interest whilst recognising its legal nature as a profit share as opposed to a performance fee) to the list of charges outside the scope of the charge cap is the correct approach. Certain performance-based incentive arrangements structured as profit shares, like carried interest, are in many other contexts, not characterised as fees or charges. We believe that amendments to the regulations should recognise these distinctions and that the DWP's policy aim would be better achieved by adding a separate subsection to the regulations, based on the approach we suggest in our answer to Q3 below.

Question 1c: If you do not believe that the proposal outlined in this consultation is the right solution to the barrier posed by the regulatory charge cap, what might be a more effective solution?

Subject to our comments elsewhere in this response, we support the outlines of this proposed solution.

Question 2: How can we ensure members of occupational DC pension schemes invested in default funds are sufficiently protected from high charges, whilst adding the performance related element of performance fees to the list of charges outside the scope of the charge cap?

Higher charges (management fees) are not necessarily undesirable

We think there may be some ambiguity here around what is meant by "the performance related element" of performance fees. It seems to us that performance fees by their very nature are entirely performance related. This element of this question may intend to highlight the distinction between fixed charges and variable performance-related payments. In the traditional PE/VC fund context, this is the distinction between management fees (the "2") and carried interest (the "20").[4] This is an important distinction to make, as we understand DWP's proposal is that management fees will remain within the scope of the charge cap whilst carried interest and other performance-related payments will be moved out of scope.

This welcome change will not disguise the fact that, despite some variation in management fees across different types of PE/VC fund (or even between managers of similar funds) the "charges" that remain subject to the cap for PE/VC funds (i.e. management fees) will remain high relative to some other asset classes, in particular listed strategies. This is because investing in and then managing illiquid portfolios of unlisted companies in a way that increases their value over several years before exit is much more involved and specialised than investing and managing portfolios of tradable instruments that do not confer significant influence or control over (and therefore responsibility for) the investee company. We explain the active nature of the PE/VC investment model and the role of PE/VC fund management fees within the broader economics of a PE/VC funds in more detail in Appendix III. Although investment costs should be clear and sit high amongst trustees' priorities, we do not believe that relatively higher PE/VC fund management fees are necessarily cause for concern, where they form the foundation of an engaged illiquid investment strategy that offers the prospect of enhanced returns. In any case, PE/VC fund management fees may face additional downward pressure in the DC context given the sensitivity of the UK DC market to even small increases in 'price'. For this reason, we do not think extra protections will be required against high charges, such as management fees, that remain within the scope of the cap.

Regulation and competition keep fees and charges within market norms

We understand DWP's concerns that pension savers should be protected from predatory charges. As an industry association, we share the Government's interest in avoiding this outcome. However, we think this is a highly unlikely outcome of the proposed policy.

[4] These numbers are used for illustration. In reality, there is considerable variation in the precise percentage used in each element. Typical management fees for some larger buyout funds are often closer to 1.5% for example. See Appendix III for further detail.

Firstly, PE/VC fund managers themselves are constrained by regulation and market forces from charging egregious fees or agreeing unusually generous performance fees or carried interest arrangements. Our members are regulated in the UK by the FCA under either or both of AIFMD and MiFID. They have many regulatory duties, including a duty to treat all investors in their funds fairly. Terms that exploited the unfamiliarity of a DC scheme with the asset class or the scheme's particular operational or other requirements to the detriment of that investor but not other investors in a fund would threaten the firm's licence to do business. From a commercial perspective, it is important to note that PE/VC firms are trusted as the stewards of capital belonging to large and highly sophisticated global institutional investors (40% of which are pension funds). The illiquid nature of PE/VC fund assets places a particular premium on personal networks and close, long-term relationships with this investor community. In this context, trust and reputation are critical and any hint of nefarious or predatory practices can be highly damaging to a firm's broader business. However, perhaps the most important point here is that PE/VC fund managers themselves operate in a broader competitive market. DC schemes will, if the proposed changes are enacted thereby providing momentum to the resolution of other challenges, be presented with a market consisting of hundreds of different PE/VC fund managers in the UK alone (and we expect they will look wider than that). As with any market, competition will maintain pricing within the boundaries of what is acceptable to fund managers and investors. Any fund manager that crosses those boundaries will lose business, and any egregious or overly generous terms are therefore unlikely to survive past a term sheet.

Secondly, DC schemes are sophisticated investors with fiduciary and other regulatory duties, including the duty to take appropriate advice under section 36 Pensions Act 1995 (and the Occupational Pension Schemes (Investment) Regulations 2005) before "investing in any manner". Appropriate advice must be from a third party, which in practice, if in the UK, must be an FCA-authorised firm. That third party may be an FCA-authorised subsidiary of the trustee itself, but this still qualifies as external advice under the rules. Third party advice from an FCA-authorised firm will very likely be required for a second reason. This is because an OPS trustee can avoid the need itself to be FCA-authorised if, when taking a "day-to-day decision" to invest in a particular fund it obtains and considers such advice (FSMA 2000 By Way of Business Order 2001, as amended). In the context of LTAFs, the rules require managers to conduct an annual assessment of value to determine whether an LTAF offers value for investors, which must be publicly disclosed. This provides a further deterrent against LTAF managers charging egregious fees because, were this to happen, the market would be fully aware, to the detriment of any such manager. These requirements for specialist advice prior to investment, along with the work of the PFWG and DWP's proposed guidance on the principles of well-designed performance fees, will further ensure that trustees are fully congnisant of market norms and able to identify and interrogate unusual alignment mechanisms before taking the decision to invest in a PE/VC fund.

Question 2a: Do you have any suggestions for how we can ensure that the regulations ensure members are only required to pay fees when genuine realised outperformance is achieved?

The UK/European whole-fund carried interest model achieves this inherently, because it is based on realised returns and measured from the perspective of the end of the fund's life. It may be that investors and managers will be able to design LTAFs (or indeed other vehicles) that accommodate DC schemes' liquidity needs whilst maintaining a more traditional carried interest model of alignment, but we think firms and prospective DC investors are also likely to want to explore different alignment models that may be more easily adapted to fit with DC schemes' liquidity and operational needs, such as NAV-based performance fees with high water mark provisions. These have a similar effect to carried interest in that they are only charged when the fund delivers strong performance.

However, we do not think DWP should be prescriptive about this issue. Instead it should rely on trustees to make decisions based on their fiduciary duty, appropriate advice and the guidance DWP proposes to publish on the typical features of and principles underlying well-designed performance fees i.e those that, in combination with other aspects of a fund product, effectively align the fund manager's interests with those of its investors over the long term.

In the LTAF context, the rules require any LTAF that charges performance fees to include details of the performance fees in its prospectus, alongside worked examples. DC schemes (and any investment consultants) will therefore be able to scrutinise how those fees work in order to satisfy themselves that the manager is only being rewarded for genuine outperformance. See our answer to Q4 below for our further thoughts on the importance of transparency.

Question 3: Which of these conditions should the government apply to the types of performance-based fees that are excluded from the list of charges subject to the charge cap? Are there other conditions we should consider? If supported by guidance on acceptable structures would this give confidence to more schemes?

There are too many variables and practical obstacles to a prescriptive approach

Well-designed performance fees are those that, in combination with the other features of a fund, help create a framework that effectively aligns the interests of the fund's manager with those of its investors in a long-term strategy targeting enhanced returns. This includes features that are economic (i.e performance fee rate/profit share ratio, management fee level, hurdle rate, size of PE/VC firm commitment to the fund etc.) and features that are commercial (PE/VC firm track record, investment strategy, target net return profile etc.). Different mixes of different economic and commercial features will characterise different individual fund offerings, and the different possible permutations of these characteristics will multiply further as different types of PE/VC fund are considered, and further still when different illiquid asset classes are also considered.

The consultation document rightly identifies a range of common considerations in the design of performance-based incentive arrangements. In general, many of these will be more, or less, relevant in the context of different individual illiquid fund products. For example, a high water mark provision might make less sense for a semi-open-ended fund with an income strategy than it might for an open-ended fund targeting long-term NAV appreciation, and a whole-fund carried interest model based on realised gains might be more appropriate for a closed-ended fund seeking long-term capital growth than it would for an evergreen infrastructure fund.

However, the inclusion of none of the listed features in a particular fund offering would, in itself, necessarily determine whether the entirety of arrangement might be appropriate viewed from a holistic perspective and taking the other commercial and economic characteristics of the proposal into account. This will vary significantly according to asset classes, investment strategies and individual managers and investors. Fund terms are also influenced by the changing macro-economic environment, such that market standards vary back and forth over time.

The framework must allow enough flexibility for DC schemes and PE/VC fund managers to agree appropriate performance-based incentive arrangements between themselves to suit the specific circumstances of each proposed investment mandate. There would also be significant challenges for Government in keeping such prescriptive rules up to date as market conditions and practice develop over time. It is therefore essential from a practical perspective that DWP's rules do not mandate any of these particular considerations in particular cases.

A policy that needs to spur innovation should promote flexibility

As discussed above, bringing DC schemes and PE/VC fund managers together to overcome the hurdles DC schemes face in accessing illiquid assets is a complex challenge that will require market participants, including advisers and investment consultants, to innovate. A rigid set of prescriptive rules would tie the hands of DC schemes and PE/VC fund managers in precisely the kind of situation where the flexibility to design and agree new structures is most needed.

As also discussed above, a particular area where technical innovation will be required is around the design of performance fee structures for open-ended products that work for DC schemes, for example using the LTAF. Products may arise that accommodate DC schemes' liquidity needs whilst maintaining a more traditional carried interest model of alignment, but we think firms and prospective DC investors are also likely to want to explore whether different alignment models may be more easily adapted to fit with DC schemes' liquidity and operational needs, such as NAV-based performance fees with high water mark provisions. It is critical that DWP does not stifle the necessary innovation by being prescriptive about the 'right' model for different investment strategies, as, in novel situations, the right models will only be settled upon via a process of refining and testing existing models through discussions in the market.

Specific BVCA recommendation on implementing this policy

We therefore recommend that DWP take the following approach:

- A legislative confirmation (separate to the list of charges that are outside of the scope of the cap) that DC schemes can exclude performance-based incentive structures such as profit share arrangements (e.g. carried interest) or performance fees from the charge cap calculation when:

    - investing in products that use these arrangements to incentivise active managers of illiquid alternative investments to maximise long-term returns; and

    - the trustees reasonably consider that the structure, investment strategy and net return profile as a whole offer effective alignment and value for money for beneficiaries; and

    - the trustees have considered any relevant guidance and taken appropriate specialist advice.

- Guidance from DWP on the principles that typically underpin arrangements of this nature and giving examples of how these are integrated into different approaches that already exist for various investment strategies, as a non-determinative framework to help trustees assess whether a particular performance-based incentive structure offers the alignment and value for money referred to above. As well as industry practice, this guidance should build on existing publications by regulators (e.g. FCA, ESMA and IOSCO) regarding fee arrangements for investment funds generally.

Question 4: Do you agree with our proposal to require disclosure of performance fees if they are outside the scope of the charge cap? If so, we propose this is done in a similar way to transaction costs – do you agree? Could you provide details of any new financial costs that could arise from a requirement to disclose performance fees? Please outline any one-off and ongoing costs.

We support DWP's position that disclosure to DC schemes and their members of any performance fees or other incentive arrangements like carried interest that fall outside the charge cap should be required. This is an important element of investor protection that allows investors to understand performance and contextualise returns. Fee transparency standards in the PE/VC industry are already are high and supported by regulation (under UK/EU AIFMD and/or MiFID, depending on the structure), industry templates (like those prepared by the Cost Transparency Initiative or the Institutional Limited Partners Association) and audit.

However, the format of such disclosure in a DC context needs careful consideration and may require additional context to avoid giving a misleading impression to scheme beneficiaries who may be more focussed on costs and less aware of any potential upside.

Question 5a: If we add performance fees to the list of charges which are not subject to the charge cap, do you agree that we should remove the performance fee smoothing mechanism and the pro-rating easement from the Charges and Governance Regulations 2015?

We cannot rule out the possibility of the smoothing mechanism and pro-rating easement being useful for some products in certain situations. We are also generally in favour of increased flexibility for sophisticated investors to agree with fund managers terms and structures that they consider to be appropriate for their commercial and operational requirements. The smoothing mechanism and pro-rating easement may in some cases provide such flexibility. We would therefore recommend that DWP leave these features in place and, if feasible, monitor whether DC schemes find a way to make use of them.

Question 5b: Is there a need for transitional protection arrangements to be brought in for schemes that have decided to make use of the performance fee smoothing mechanism, and if so what do these transitional arrangements look like?

We are not aware of any BVCA members that are either contemplating or have created any funds that make use of the performance fee smoothing mechanism, nor are we aware of any such products in the wider market. We therefore have no reason to suspect transitional arrangements might be necessary, although any concerns in this regard could perhaps also be assuaged by leaving the smoothing mechanism in place.

APPENDIX III: Overview of PE/VC fund economics and alignment of interests

This Appendix includes an illustrative example to explain how the economics of PE/VC 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.

- *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 the fund manager's own "co-investment"[5] requirement itself to invest in the fund (typically 2-5% of total funds raised).
    - Executives are participants in the carried interest and fund manager 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 (see below for further detail on how this package provide both upside and downside alignment of interests).
    - 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.

[5] Please note that these co-investment arrangements are an entirely different type of co-investment to those referred to in the body of our response whereby an individual investor may co-invest alongside a fund in a particular portfolio company of the fund.

- Capital is also drawn down to pay the management fee/PPS and other fund-related costs. The management fee/PPS is 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, the manager's carried interest entitlement will only be 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, and so the carried interest distributions will be retained in an escrow account until this point is reached.

- *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 share in proceeds from realisations.
    - The fund is wound down once all its investments have been sold, at which point any remaining 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.

An investment the fund manager itself makes in the fund ("co-investment") aligns managers' and investors' interests over the long-term by ensuring the fund manager shares 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 this type of co-investment is funded. It will depend on the particular circumstances of the prospective participants and the level of the commitment.