THE SOCIETY OF PENSION PROFESSIONALS
making pensions work

Submitted by email: pensions.investment@dwp.gov.uk

For the attention of Sam Haylen, Vicky Bird, Tessa Lubrun and Andrew Blair
Department for Work and Pensions

15 April 2021

Dear Sam, Vicky, Tessa and Andrew

SPP RESPONSE TO DWP CONSULTATION: INCORPRATING PERFORMANCE FEES WITHIN THE CHARGE CAP

We welcome the opportunity to response to this consultation. If the Society can assist you in further developing this thinking, we would be happy to help.

Key point summary

The Society is very supportive of the DWP seeking ways to permit a wide opportunity set for DC. However, we caution that in reality, the proposed smoothing mechanism over up to 5 years will not by itself be likely to be sufficient to encourage significant DC investment in Private Equity. There continue to be too many uncertainties and too high a risk of breach of the charges cap which is likely to put off most DC Trustees. A more radical overhaul is likely to be required to properly unlock potential demand from DC Trustees for investment in PE.

Detailed responses

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?

a) We do not have any specific comments on the performance fee regulations, however we expect their impact in practice to be limited for the reasons set out below.

b) We expect there to be limited take-up of this option by trustees for several reasons. Firstly, the regulations would not be of use in respect of illiquid investment where any performance fees do not accrue annually, and we understand annual accrual of performance fees may not be typical for existing illiquid investment options. Secondly, the smoothing approach used in the performance fee regulations does not assist trustees in circumstances where significant outperformance occurs in the first year of an investment. This puts trustees at risk of non-compliance with the charges cap if they select an investment which produces an exceptionally high return for members in the year in which the investment is made, which would seem contrary to the policy intent. Thirdly, the

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smoothing approach does not appear to accommodate smoothing over more than 5 years of investment.

c) The performance fee regulations do not address other issues which we understand affect trustees' confidence to invest in illiquid investment options, in particular lack of clarity around "look through" (see below).

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

In considering the appetite from pension scheme trustees for venture capital and growth equity, it is worth considering DC and DB separately. The majority of private sector DB schemes are closed, maturing and on a path to de-risk. As such the focus on new investments tends to be on building up the portfolio that will be held once the scheme achieves its long term objective. This means that all equity allocations are in decline and new allocations to private equity are less likely, as these schemes focus both on liquidity of their return seeking portfolios and the governance burden of what is smaller allocations to complex return seeking assets is harder to justify. In private sector pension funds, it is typically only the largest defined benefit schemes that will consider allocations to venture capital. The situation is somewhat different in public sector DB schemes, which are less mature and have higher growth assets (as well as a strong covenant). DC schemes have different barriers to investing in venture capital, of which fee structures versus fee caps is one. Others include: the scale and governance limitations of many DC schemes, the liquidity DC trustees need to provide their members and the J-curve effect, which makes daily pricing difficult.

‘Growth equity’ is a broader church than venture capital and while some market participants will take it to mean new capital into private market opportunities, in its broader sense it might be taken to include listed equity, where the value in that listed equity is not driven by current dividends but the potential for future dividends. In this context growth equity will be part of many pension schemes equity allocation, be that through their passive holdings or because they have appointed an active manager that they believe can outperform the market either with a growth style of investing or, perhaps, style neutral with allocations to growth as well as value equity.

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

As a preliminary point, we note there is no express requirement to "look-through" contained in the relevant legislation or regulations. More specifically, "look-through" is not referred to at all in the Charges and Governance Regulations 2015 or in the definition of "administration charge" in Schedule 18 to the Pensions Act 2014. We note the definition of "administration charge" operates at the level of the member's rights and any income or capital gains arising from scheme investments and does not refer to any costs below the level of scheme investments. Consequently, there is a good argument that "look-through" is not required at all by the relevant legislation or regulations.

In light of this, trustees who attempt to apply "look-through" in practice have to base their approach solely on a variety of guidance and consultations issued to date by the DWP rather than applying a clearly defined regime. This is unhelpful given the typically long-term nature of illiquid investments and the costs of exiting such investments, given the risk that current guidance may change during the holding period of an investment or that the Pensions Regulator or a court might disagree with DWP guidance in relation to the application of "look-through".

More generally, the application of "look-through" in practice is unclear and impractical. By way of example, many publicly listed UK companies will, within their corporate structure, include companies, partnerships or individuals receiving performance fee, advisory fees, carried interest or remuneration structured in a similar way. If these listed companies are characterised as "investment companies" rather than having a "general commercial or industrial purpose" (which may seem plausible for some listed companies), would DWP's intention be that "look-through" should be applied? In practice, our experience is that trustees investing in a fund which includes shares in listed companies of this sort would not expect to apply "look-through" in these circumstances. Attempts to apply the current DWP guidance and consultations can produce very arbitrary results, seemingly requiring or not requiring look-through depending on the investment vehicle used for otherwise similar investments.

In addition, even if trustees do conclude that "look-through" should apply in such circumstances, it may be very difficult for trustees to obtain accurate and timely information about any underlying costs of this sort (in the absence of a clear statutory requirement on investee companies or funds to provide such information) or to straightforwardly incorporate such costs into the existing charge cap framework even if it could be obtained.

We also note that performance fees occurring lower down within an investment structure will not necessarily be directly reflected in the level of investment return received by the trustees, which will be driven by a wider range of factors, costs and decisions made within the investment structure. Consequently, it is not clear how trustees are expected to determine the exact amount of investment 'drag' generated by performance fees in these circumstances or how to suitably incorporate them into the charge cap calculations and communicate them to members.

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

Yes, in our experience it can act as a significant barrier to investment. Trustees will generally be hesitant to make an investment if there is uncertainty around whether "look-through" applies at all, how far through an investment structure they are required to look, what types of costs are properly in scope, and how the relevant information can be obtained. This uncertainty could cause trustees to decline to make an investment even if they otherwise consider it to be in the best interests of the scheme membership to do so.

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

In addition to "look-through", other barriers to investment in pooled illiquid investment vehicles include how to effectively manage liquidity (e.g. when DC members transfer out or make an investment switch), how to value such investments on a regular basis, and how to obtain agreement from commercial fund providers to fee structures which trustees can be confident are compliant with the charge cap.

We do not believe that headroom below the charges cap will mean that trustees are willing to make investments which involve performance fees which will count against the charges cap. The charges which will be borne by members are typically communicated as set percentage of contributions or assets under management. Trustees manage their charges carefully and it is unlikely that trustees will be willing to tolerate the uncertainty and unpredictability of performance fees which count against the charges cap (which would also increase the complexity of member communications).

The application of the charge cap to performance fees may also create a perverse disincentive against investing in investments which may perform particularly well, which would increase the performance fees and therefore potentially put the trustees in breach of the charges cap. Trustees may be reluctant to make investments which may generate significant outperformance because of the increased risk this would create of breaching the charges cap.

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?

We consider that the current approach to "look-through" would need to be fundamentally revised or removed altogether if it is to cease to act as a barrier to investment in illiquid investment vehicles. One alternative would be to amend the DWP's guidance to clearly state that "look through" is not required, and there is a good argument that this would better reflect the current position under the charge cap legislation. We consider that trustees' existing fiduciary duties could provide a suitable safeguard in respect of taking into account underlying costs within an investment structure. Alternatively, if "look-through" is retained, we consider that a workable regime would need to be set out in clear guidance from the DWP which provides sufficient clarity about exactly when DWP considers "look-through" is required for different investment structures, how trustees can obtain the necessary information (and what to do if the information cannot be obtained) and worked real-life examples of how the "look-through" process is intended to be applied in practice and incorporated into the wider charge cap system. This would require a significant revamp of existing guidance rather than simply adding to the existing non-exhaustive list.

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

Requiring "look-through" in respect of some classes of investment but not others would, other things being equal, seem to potentially increase the risk of arbitrage in the sense that we expect trustees would be more likely to invest through a vehicle if they could be confident that "look-through" does not apply to it as compared to a substantively similar investment where "look-through" does apply.

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

In our view the meaning of venture capital is well understood. The CFA Institute, which is the preeminent global investment qualification, has a glossary that defines it as:

Private equity investment in development stage companies. Investors in venture equity would see it as having a high return potential but also high risk, so would seek diversification, quite probably through a fund of funds.

As eluded to in question 2, there is much less clarity and agreement around what is meant by Growth Equity and its meaning is likely context specific. It is not a term defined by the CFA glossary.

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

As part of the Government's work to set up and launch the new Long Term Asset Fund, it will be important for issues relating to the charge cap and look-through to be robustly and clearly addressed in order to give trustees the confidence to consider investing in funds of this sort. It would seem to be contrary to the Government's policy goal if trustees were dissuaded from making an

illiquid investment which they consider to be in the best interests of scheme members simply because of uncertainty around the technical regulatory requirements of the charges cap.

As noted in response to question 6, an alternative approach which might significantly simplify this issue would be for the DWP's guidance to be amended to state that "look-through" is not required. Trustees are already required under their fiduciary duties (and could be encouraged by guidance) to have due regard to underlying investment costs when making an investment, but these costs could not need to be formally incorporated into charge cap calculations. This approach would allow trustees to take into account available information about underlying costs when making investment decisions in best financial interests of members, without requiring a complex framework to be designed to accommodate different investment structures and the charge cap calculation process. Many trustees may choose not to invest in venture capital or growth equity, but for those trustees who decide that such investments would be in members' best financial interests it would be unfortunate if they were deterred from making such investments because of the uncertainties and impracticalities of the charge cap requirements.

A further proposal which the Government could consider would be to exclude performance fees from the charge cap calculation altogether, on the basis that these fees only arise when there has been outperformance which has benefited members. The Pensions Regulator or DWP could supplement this approach by publishing guidance indicating what it considers to be appropriate parameters for performance fees in the context of trustees' broader fiduciary duties to invest in members' best financial interests.

Yours sincerely

Fred Emden
Chief Executive, SPP

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