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DC Policy, Investment and Governance Team
Department for Work & Pensions
Caxton House
Tothill Street
London
SW1H 9NA

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

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Dear DC Policy, Investment and Governance Team

Re: Broadening the investment opportunities of defined contribution pension schemes

The BVCA is the industry body and public policy advocate for the private equity and venture capital (PE/VC) industry in the UK. With a membership of over 750 firms, we represent the vast majority of all UK-based PE/VC 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 PE/VC funds currently employ over two million people in the UK and 90% of the businesses our members invest in are small and medium-sized enterprises.

We support the Government's policy objectives for these proposals

We welcome the Government's principles-based proposals to broaden the investment opportunities available to defined contribution (DC) pension schemes. The regulatory charge cap is a key barrier to DC investment in less liquid assets, including PE/VC, and, subject to our comments below, we believe the proposed exemption for performance-based fees will help schemes access the strong risk-adjusted returns and diversification benefits that private capital can deliver.

PE/VC funds have historically provided diversification and strong returns for various UK and international institutional investors, including UK defined benefit (DB) and overseas DC pension schemes. When comparing the investment performance of the UK PE/VC industry with public markets, the five-year and ten-year annual returns were 21.1% and 13.9% respectively, compared to the FTSE All-Share, which returned 5.1% and 5.6% to investors over the same respective periods.[1] So, there is a powerful potential for DC pension schemes to improve the retirement outcomes for scheme members through greater allocations to private capital. As well as delivering positive, long-term, investment outcomes for investors, UK-managed PE/VC funds also play a vital role in the growth of the economy and support over two million jobs across the UK.[2]

We welcome the opportunity to feedback on the Government's proposals and have responded to consultation questions on which our members have specific views.

Question 1: Do you have any comments on the draft regulations in relation to the disclose and explain provisions? Please include in your answer any comments on whether you consider they meet the stated policy intent.

We support the Government's stated policy intention to facilitate greater diversification in schemes' investments, particularly through allocations to less liquid assets, and to encourage greater transparency around investment decisions. However, we defer to the DC pension scheme trustees and managers and other relevant stakeholders to provide detailed comments on the disclose and explain proposals for illiquid investment.

[1] Performance and Public Market Equivalent Report 2020
[2] Measuring the contribution of PE/VC to the UK economy 2021

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Question 3a: Do you have any comments on the proposed regulatory asset allocation disclosure requirements included in the draft statutory guidance?

The draft statutory guidance on 'Asset allocation disclosure' at paragraph 24 requires a closer look as certain investments could fall into more than one asset class. Conversely, we suggest that the definition of "bonds" at 24 b. is too narrow, as US Treasuries, for example, would be defined as private debt/credit by 24 g..

Question 3b: Are there any areas where further clarity might be required?

We note the guidance does not contain any specific discussion on how trustees should approach the consideration of and disclosures around managing liquidity risk. The Productive Finance Working Group has identified liquidity management as an important consideration for DC schemes. We agree with that focus, in particular for schemes that may be considering accessing illiquid assets through open-ended fund structures. Although we defer to other stakeholders on whether the DWP guidance and the disclose and explain provisions constitute the right location for guidance for DC schemes on this issue, we encourage DWP to consider whether it might be, perhaps through explicit reference to work of the PFWG on this topic.

Question 6: Do you have any comments on the draft regulations in relation to the performance fee measures? Please include in your answer any comments on whether you consider they meet the stated policy intent.

Noting the Government's intention to enable DC pension scheme trustees and managers to invest in less liquid assets, including through PE/VC funds, we have the following recommendations on the draft regulations in relation to exempting performance-based fees from the regulatory charge cap for default schemes.

1. Definition of a "specified performance-based fee" needs to include profit-share arrangements like carried interest

The Government noted in its consultation outcome on enabling investment in productive finance that a common performance-based fee structure is a combination of a fixed annual management fee, paid on the value of committed capital, and a performance-based element, calculated on investment returns over a hurdle rate, known as "carried interest". We understand that the Government's intention is to exempt the "performance-based element", meaning performance-based fees and carried interest, from the regulatory charge cap.

We deliberately draw a distinction between "performance-based fees" and "carried interest" as the latter is not strictly a fee but a profit-share arrangement agreed between investors and a fund manager (typically as partners in a limited partnership). These arrangements are the market standard means of aligning the interests of a PE/VC firm with those of the investors in the funds it manages, to reward the sustainable and long-term growth in value of those funds' portfolio companies. Therefore, it is important to ensure that the proposed definition of a "specified performance-based fee" clearly includes profit-share arrangements like carried interest, as well as performance-based fees. This will ensure that DC schemes are able (subject to other considerations than the charge cap) to invest in market standard PE/VC funds as well as any products that may be designed specifically to accommodate the needs of DC scheme investors (e.g. liquidity, fairness between members, operational considerations, etc.).

To address this issue in the draft regulations, we recommend amending the definition of a "specified performance-based fee" to include "profit-shares" that also meet the conditions set out in limbs (a) to (e). In our view, the explicit inclusion of "profit-shares" would bring carried interest inside the definition and enable DC pension scheme trustees and managers to apply the charge cap exemption to invest in market standard PE/VC funds, as we understand was intended.

We believe that subject to the following recommendations (2 and 3 below), the subsequent limbs ((a) to (e)) in the definition are sufficient to restrict the proposed exemption to those performance-based fees and "performance-based elements" of common structures (i.e. carried interest) that are intended to be in scope.

Recommended amendment(s):

"specified performance-based fees" means fees or profit-shares, or any part of ~~those fees~~ them, which are—

2. Performance-based fees "or profit-shares" are not necessarily paid by DC scheme trustees or managers, nor only to fund managers

We recommend that limb (a) of the definition of a "specified performance-based fee" be amended to reflect that, in reality, the performance-based element is not necessarily "payable" "by the scheme trustees or managers" "to a fund manager". In the case of profit-share arrangements like carried interest, this element instead "arises from" investments (i.e. the fund or its underlying assets) that a PE/VC firm manages. These may be allocated directly from the fund's profits as they arise to the firm and those of its affiliates (whether technically "fund managers" or not) on whose efforts the fund's success most depends. It is often the case that the individuals driving the long-term success of a particular portfolio company investment may have little role in the management of the fund as a whole (as opposed to certain of its investments) and could be considered more akin to entrepreneurs or investment professionals than "fund managers".

We believe that the flexibility needed to accommodate both specified performance-based fees as well as profit-share arrangements, including carried interest, can be achieved in the draft regulations by amending the regulations as indicated below. The words "by the trustees or managers of a pension scheme to a fund manager" in limb (a) should be deleted because they are restrictively prescriptive as regards the payment mechanics, in a way that could exclude carried interest arrangements as described above. We have also suggested text to recognise that profit-shares "arise from" investments to which a pension scheme "has exposure". The current wording in limb (a) of the definition, requiring investments to be managed by the fund manager for the purposes of the pension scheme, would limit the application of the exemption on a look-through basis and unnecessarily restrict DC pension scheme investment to funds that are directly invested in less liquid assets. To address this and provide DC pension schemes with greater investment and investment structure options and opportunities, we recommend that limb (a) of the definition includes fees payable in relation to, or profits-shares arising from, investments to which a pension scheme has "direct or indirect exposure". In line with the Government's policy objective, this will broaden the investment opportunities of DC pension schemes, help to level the playing field with overseas pension schemes that invest in UK PE/VC funds, and provide opportunities for greater investment diversification for the reasons set out in 3. below.

Recommended amendment(s):

"specified performance-based fees" means fees or profit-shares, or any part of ~~those fees~~ them, which are—

(a) Payable ~~by the trustees or managers of a pension scheme to a fund manager~~ in relation to, or arise from, investments ~~managed by the fund manager for the purposes of the~~ to which a pension scheme has direct or indirect exposure;

3. Investment in Funds of Funds, Long-Term Asset Funds, and unforeseen circumstances

Funds of Funds

A PE/VC fund of funds (FoF) is a fund that invests in other PE/VC funds which in turn invest in underlying unlisted portfolio companies. From a DC scheme perspective, there may be benefits to investing in less liquid assets through FoFs, such as greater diversification and reduced concentration risk, and this could be an attractive investment option for schemes.

However, the current drafting of Regulation 2, requiring the rate, amount, period of time or term to be "pre-agreed" between the DC pension scheme trustees or manager and the fund manager before the scheme invests may exclude FoF investments from the regulatory charge cap exemption. This is because there will be performance-based fees and profit-share arrangements in each of the funds underlying the FoF. To the extent these fees or other amounts would otherwise fall in-scope of the charge cap and the proposed exemption for specified performance-based fees on a look-through basis, these fees or other amounts cannot be "pre-agreed" between the trustees or managers and the relevant underlying fund manager because there is no direct agreement or relationship between those parties. It is for the FoF manager to negotiate and agree those terms on behalf of investors in the FoF. It is worth noting that the FoF manager has a commercial interest and performance incentives to ensure the fees or other amounts agreed with the managers of underlying funds are as favourable as possible for the FoF investors.

Long-Term Asset Fund

DC pension schemes may also be interested in investing via the Long-Term Asset Fund (LTAF), which is a new type of authorised fund designed to help investors like DC schemes to invest in long-term, illiquid assets. The LTAF is expected to appeal to DC schemes looking for exposure to less liquid assets because of its open-ended nature. The FCA has recently consulted on proposals to extend the distribution of LTAFs and other illiquid assets more broadly amongst members of DC pension schemes, beyond default arrangements.

However, the requirement for specified performance-based fees to be "pre-agreed" could cause problems for DC schemes seeking to invest in LTAFs and other types of open-ended fund. This is because open-ended funds are frequently, if not continually, open to new investors and in turn make new investments/divestments in funds and underlying assets on a regular basis. Investors coming into an open-ended fund after launch will typically have to agree to terms that have been agreed to by existing investors and it is also possible that LTAFs will be structured as FoFs. It is therefore potentially unfeasible for terms to be "pre-agreed" with trustees or managers before the investments to which the specified performance-based fee relates are made.

To solve the issues that the current drafting may present for DC schemes seeking to invest in FoFs, LTAFs and other open-ended funds, we recommend removing the requirement for the rate, amount, period of time or term of specified performance-based fees to be "pre-agreed" before "investments to which the fees relate". We suggest, in light of the issues identified, the Regulations need only to require that these terms are "agreed".

On a separate but related note, it may only be feasible for the trustees or managers of the pension scheme to agree to terms where the scheme is invested directly in the investments to which the specified performance-based fees relate. For example, where the trustees or managers of a scheme choose to invest in a PE/VC fund that invests in unlisted SMEs. Where the trustees or managers of a scheme choose to invest in a FoF or LTAF (and it is perhaps worth noting here that the default arrangements to which the charge cap applies will be managed by professional investment managers), for the reasons set out above, on a look-through basis, the scheme will be indirectly invested in investments on which specified performance-based fees could become payable or on which a profit-share arises. To enable DC schemes to invest in underlying PE/VC funds through FoFs, the Regulations will need to reflect that the terms are agreed between (i) the FoF manager, acting in the best interests of FoF investors (as they are required to do under law and regulation), and (ii) the manager of the underlying funds or vehicles through which exposure to the less liquid assets is obtained. We therefore recommend (1B) limb (a) be split out to recognise both direct and indirect exposure, which tracks through from the reference to direct or indirect exposure made in our recommended amendments to limb (a) of the "specified performance-based fee" definition (see 2.).

Unforeseen circumstances

It is also important for the definition to recognise that there may be a need to reorganise a fund's economics during its life, for example in response to a change in market circumstances (fees may need to be reduced) or a macroeconomic shock event (such as the global financial crisis, where investors sometimes sought to renegotiate lower fixed fees to reduce costs whilst increasing carried interest (paid on realised returns) to

incentivise turnarounds). The current wording in limbs (c), (d) and (e) of the "specified performance-based fees" definition and (1B) limb (a) requires the rate, amount, period of time or term to be "pre-agreed" before investment to qualify for the exemption. This may not always be desirable or compatible with investors' best interests, and we recommend building in greater flexibility to allow investors in negotiation with their fund managers to respond to such circumstances. Again, this can be resolved by requiring specified performance-based fees to be "agreed", and not "pre-agreed".

> Recommended amendment(s):
>
> (c) only payable when—
>
> (i) investment performance exceeds an ~~pre-~~agreed rate, which may be fixed or variable; or
>
> (ii) the value of those investments exceeds an ~~pre-~~agreed amount;
>
> (d) calculated over an ~~pre-~~agreed period of time; and
>
> (e) subject to ~~pre-~~agreed terms designed to mitigate the effects of short-term fluctuations in the investment performance or value of those investments;";
>
> […]
>
> "(1B) When determining whether or not fees or profit shares, or any part of ~~those fees~~ them, are specified performance-based fees for the purposes of these regulations—
>
> (a) a rate, amount, period of time or term is ~~pre-~~agreed if: ~~it has been agreed between the trustees or managers and the fund manager to whom the fees are payable, before the trustees or managers make investments to which the fees relate~~
>
> i. where the pension scheme invests directly in the investments to which the fees relate, it has been agreed by the trustees or managers of the pension scheme; or
>
> ii. where the pension scheme invests indirectly in the investments to which the fees relate, it has been agreed by the person or vehicle through which the exposure to the investments is obtained; and
>
> (b) the trustees or managers of the scheme must have regard to any guidance issued by the Secretary of State by virtue of paragraph 1(2)(b) of Schedule 18 to the Pensions Act 2014."

Question 7: Are there other elements not covered in these regulations that you would expect to see?

Subject to the above amendments, we believe the proposed regulations will deliver the Government's policy objective to exempt specified performance-based fees, including carried interest, from the charge cap.

Question 8a: Do you have any comments on the performance fee sections of the draft statutory guidance?

The criteria for specified performance-based fees, at paragraph 49, would need to be updated to reflect any changes to the legislative definition. Our recommendations are set out in our response to Question 6. Similarly, the title and explanation of 'Pre-agree rate or amount', at paragraphs 52 through 59, would need to be updated to reflect any changes to the legislative definition of a specified performance-based fee.

Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor ttaylor@bvca.co.uk / Nick Chipperfield nchipperfield@bvca.co.uk).

Yours sincerely,

Tim Lewis, Chair, BVCA Regulatory Committee