CFA Society
United Kingdom

16 April, 2021

Sam Haylen, Vicky Bird, Tessa Lubrun, Andrew Blair
Department of Work & Pensions
DC Policy Team
Policy Group Private Pensions and Arm's Length Bodies Directorate
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Submitted by E-mail to: pensions.investment@dwp.gov.uk

Dear Mr Haylen, Ms Bird, Ms Brun & Mr Blair,

CFA UK response to DWP on further Consultation re: Incorporating performance fees within the charge cap (the "Consultation")

The CFA Society of the UK (CFA UK) welcomes the opportunity to share its views on this further consultation which seeks to find a remedy to a number of issues relating to the present formulation of the charge cap for DC pensions schemes. CFA UK notes that since its introduction the charge cap has played an important role in helping to reduce the level of fees incurred by pension schemes and continues to regard it as a force for good cost discipline on the pension management sector.

Our responses to the specific questions in the Consultation are provided in Appendix II. In summary, we propose that:

- Performance fees are removed from the charge cap calculation, subject to appropriate minimum hurdle rates and proper disclosure;
- All listed vehicles such as REITs and investment trusts should be excluded from the look-through provisions.

These moves, however, would need to be accompanied by a package of disclosure requirements and structural constraints to ensure members' interests continue to be protected from the risk of excessive and egregious fees in line with scheme's wider regulatory obligations.

Yours sincerely,

Will Goodhart,
Chief Executive
CFA Society of the UK

Andrew Burton
Professionalism Adviser
CFA Society of the UK

With thanks for the contributions from CFA UK's Pension Expert Panel and the oversight of CFA UK's Professionalism Steering Committee

Appendix I: About CFA UK & the CFA Institute

CFA UK: serves nearly 12,000 leading members of the UK investment profession. Many of our members work with pension funds, either managing investment portfolios, advising on investments or as an in-house employee responsible for pension investment oversight.

- The mission of CFA UK is to build a better investment profession and to do this through the promotion of the highest standards of ethics, education and professional excellence in order to serve society's best interests.

- Founded in 1955, CFA UK is one of the largest member societies of CFA Institute (see below) and provides continuing education, advocacy, information and career support on behalf of its members.

- Most CFA UK members have earned the Chartered Financial Analyst® (CFA®) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute: is the global association for investment professionals that sets the standard for professional excellence and credentials.

- The organization is a champion of ethical behavior in investment markets and a respected source of knowledge in the global financial community. Our aim is to create an environment where investors' interests come first, markets function at their best, and economies grow.

- It awards the Chartered Financial Analyst$^{®}$ (CFA), and Certificate in Investment Performance Measurement$^{®}$ (CIPM) designations worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry.

- CFA Institute has members in 162 markets, of which more than 170,000 hold the Chartered Financial Analyst$^{®}$ (CFA) designation. CFA Institute has nine offices worldwide and there are 158 local member societies.

- For more information, visit www.cfainstitute.org or follow us on Twitter at @CFAInstitute and on Facebook.com/CFAInstitute.

Appendix II: Responses to Questions

Q1: 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?

The current treatment of fees under the charge cap, in terms of the timeframe for their measurement, makes investing in vehicles with performance fees essentially impossible – so we commend the DWP for proposing a solution to this aspect of the wider private market fees challenge.

While there is not necessarily any great ambiguity in the proposed performance fee smoothing mechanism, we do believe that it could be inordinately complex to implement in practice. While this complexity is *not going to be the major limiting factor for reasons we will address below*, it should not be underestimated. Pensions schemes are prudently risk averse – and a key risk they aim to minimise is operational risk; as it pertains to fees, we see schemes opting for very simple member charging mechanisms (which have the added virtue of being easy to communicate to members and being eminently comparable). We expect few if any schemes to voluntarily adopt a much more complex charging mechanism that requires tracking numerous individual members over multiple time periods.

The even greater hurdle, that the proposed solution will not overcome however, is the magnitude and pattern of private market fees; we do not believe that schemes will be able to, or be prepared to, afford both management fees and carried interest;

- Schemes will face an extant legal risk that their investment in a 'fee plus carry' vehicle will lead to an inadvertent breach of the charge cap.
- Schemes face a very significant commercial risk that having a much higher and more volatile headline fee than their peers could seriously undermine their marketing proposition, even despite any efforts to extol the benefits of their having invested in a private market.

We note the modelled scenario from Oliver Wyman, included in the consultation document, which demonstrated that – in a not unreasonable scenario – a scheme makes a meaningful allocation to private equity and comfortably remains under the 75bps charge cap. It is crucial to acknowledge however that this modelling is not exhaustive, and the simple fact remains that schemes could conceivably breach the cap through an allocation to a successful investment; and such a risk is one we don't think many trustees will be prepared to take[1].

We think it is also crucial to acknowledge that (on the basis of the typical private equity '2&20' fee arrangement), even where the risk of charge cap breach due to the performance fee element can be accepted or otherwise engineered away, adding a 0.2-0.3% additional charge to a scheme's headline member charge, for only a 10% allocation to, say, a private equity fund is unlikely to be taken up by most. The European Commission Delegated Regulation (EU) 2017/653 already requires a 5-year

[1] This is risk is especially great in venture capital and growth equity, where large returns may be realised towards the end of a programme when, for example, a company has a very successful IPO. These so called 'unicorns' are part of what attracts investors to the asset class, but perversely could cause some considerable concern to a DC scheme with some exposure to them, given the confines of the charge cap.

smoothing of carried interest under PRIIPs[2]. It is currently relatively common that when applying this 5-year carried interest smoothing rule carried interest can still amount to 3%-5% for successful investments. A 10% allocation to strongly performing private assets by DC savers can still generate an annual charge exceeding 0.5% pa in any one year. This, in addition to the charges on DC savers' other investments, can then easily propel total charges above the charge cap relatively easily.

The DWP acknowledge that, nearly a decade on from automatic enrolment and the charge cap, the market has coalesced around pricing in the region of 0.2-0.5% for large schemes; it is reasonable to assume that will remain stable henceforth.

The challenge therefore, is if and how private market investments can be made to fit broadly within the DC industry's pricing equilibrium. It is important to reiterate at this point that, for all practical purposes, we should not anticipate a significant change to the business models of private market managers – their competitive environment is very supportive to defending their margins. This leads us to conclude that DC schemes and private market managers will, on the whole, be only able to meet in the middle if performance fees can be treated as a disclosable drag on performance – just like transaction costs – but not part of what the industry collectively expresses as a headline member fee. We therefore recommend that performance fees be removed from the charge cap.

This model would, we believe, potentially allow for an exploratory conversation between schemes and private market managers about much lower annual management fees (that can be accommodated in the 0.2-0.5% overall scheme budget), offset by paying a larger share of good performance over a reasonable hurdle rate. Hurdle rates of course should be appropriate for the risk and expected return profile of the underlying asset class.; for private growth equity, for example, the hurdle rate should represent a premium over the expected returns[3] public small and mid-cap shares.

We believe this framework could stimulate a meaningful allocation from the DC industry to private markets and alternative assets; increasing expected risk adjusted returns for members, ensuring value for money (fees being paid where they are rightly earned) with no detriment to the vital consumer protection that the charge cap ensures. Additionally, we believe this framework would be transparent and provide for intuitive comparison of fees and value for money across schemes: the fixed percentage management fee component can be evaluated just as it is today, while net returns (and net versus gross) returns can be compared and evaluated to discern if any performance fee component is offering value.

Regardless of the approach taken to performance fee disclosure, careful consideration needs to be given to helping members understand (i) the extent to which they may have benefited from performance and (ii) the extent to which they will have had to share the burden of the costs relating to it and (iii) the potential disconnect between the two as a result of the timing differences between individual contributions and realised performance in VC and PE funds. CFA UK explored the

[2] P42, Para.25: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017R0653&from=EN.

[3] CFA UK would advocate using forward-looking capital market assumptions, which are published by a large number of investment institutions, in setting benchmark returns for hurdle rates; the historical performance of an index or a manager's track record is unlikely to be appropriate.

complexities and risks of different performance fee structures in their recent research paper "Innovations in retail fund fees".[4]

Q2: What is the likely appetite that pension scheme trustees have for investment in venture capital and/or growth equity?

DC schemes, as large institutional investors with very long investment horizons, positive cash flow profiles and reasonably ambitious return targets should, all else equal, find venture capital/growth equity – and private assets more generally – very attractive, just as their DB and other institutional peers may.

Naturally, the appetite for levels of investment risks will differ from one scheme to the next – many might find venture capital just too risky while others may take a view that they can diversify this risk at scale. If the industry and regulators can coordinate a blueprint for investing in private markets that overcomes the significant practical hurdles that schemes face in making these investments, then no doubt they will. Such a blueprint needs to address both the operational and commercial challenges – we are hopeful the Long-term Asset Fund project in combination with the conclusions of this consultation process will constitute a considerable leap forward towards that objective.

Q3: How do you currently treat look-through when calculating the charges regime of the scheme?

The CFA Society UK does not run a pension scheme and hence does not have an established method of treatment. However, we do recognise the ambiguity and complexity in this issue. We would like to offer the following thoughts on what we believe is reasonable, practicable, and consistent with what we understand are the two major policy aims of (i) facilitating investment in private markets while (ii) protecting consumers from excessive or egregious fees.

Most importantly, we would reiterate our previously stated opinion that applying look-through to investments listed on recognised exchanges – real estate or otherwise – poses an enormous[5] challenge to DC schemes. We believe that to varying degrees (depending on the securities and the markets they list in) such an approach would be impossible, unwieldy and arbitrary[6].

We believe that schemes making investments in unlisted vehicles and funds absolutely should, however, examine total fee drag embedded in that vehicle when evaluating value for money – where it is too high, they should look elsewhere or negotiate it down. We note that these are options that are absent when a scheme has passive exposure to listed vehicles (other than to seek to

[4] "Innovations in retail fund fees" (https://www.cfauk.org/professionalism/research-and-position-papers/innovations-in-retail-fund-fees#gsc.tab=0)

[5] Please see part b) our response of 30 October, 2020: https://www.cfauk.org/-/media/files/pdf/pdf/5-professionalism/2-advocacy/responses/dwp-improving-outcomes-for-dc--oct-2020.pdf

[6] We note that the effect of embedded fees on returns in listed versus unlisted vehicles is rather different. As with most listed shares, a considerable portion of the returns for holding listed REITs or other investment funds/companies comes from changes to the market price of the shares. While we do not want to to dive into the academic debate about the extent to which market beta dominates the underlying assets in the return profile of REITs (and other funds/companies), we think it is safe to conclude that the impact of embedded fees will have a negligible impact on the level of premium/discount to, and volatility around, NAV which the share happens to trade at on a given day. In other words, like all shares, whether these shares are cheap or expensive depends primarily on the price paid for them, and much less on the fees embedded in them.

restructure the benchmark, move to a segregated account etc. so that specific stocks can be excluded).

The extent to which look through of unlisted vehicles should fall within the formulation of members fees under the charge cap is a complex issue: too permissive a regime could be exploited to bury fees, while too restrictive a regime will practically limit schemes' abilities to access certain asset classes. On balance, we believe there should be a general principle of look-through on unlisted funds/vehicles.

There may be a case for allowing some carve-outs, with respect to unlisted funds and structures, to facilitate innovation in accessing private markets where the structure is demonstrably value accretive to members and not simply creating an opaque fee-multiplier – however, that is likely to be difficult to regulate in practice, especially from the outset and might be a matter for later detailed consultation.

Q4: Does look-through act as a significant barrier to investment into investment vehicles that allocate to VC/GE?

In general, counting more fees in a structure rather than fewer is going to be a barrier for DC schemes who are operating on thin budgets for investing.

Structures like funds of funds, for which look through is a major issue, are prevalent in the venture capital and growth equity because most asset owners are unlikely to be able to build up the network of high calibre general partners necessary for making a meaningful and diversified allocation to this space. Venture capital investments, by definition, involve relatively small ticket sizes, often through GPs that specialise in a niche such as biotech, for example; as such pension plans largely have to rely on fund of funds managers to due diligence and aggregate exposures on their behalf.

We believe most schemes will struggle to implement a VC/GE programme without a fund of funds structure but equally may struggle to afford one, especially if required to look through on fees.

Q5: Are there more significant barriers to the success of pooled illiquid investment vehicles than look-through? If so, what are they?

For larger schemes, we presume that the absolute level of the fee burden – including both look through and performance fees – is the major obstacle to uptake of illiquid investment vehicles, pooled or otherwise. For smaller schemes the issue of fee burden may be somewhat academic as the operational complexity and governance oversight challenges of making an investment in illiquids may put them off anyway. As noted above, the LTAF may help smaller schemes overcome the latter, to some degree.

Q6: 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 refer to our answer to Question 3 above; we appreciate the complexity of the issue but would lean towards a more permissive position than restrictive one so as not to curtail potential investment in private markets.

We note that current legislation is permissive enough in that it requires that schemes consider administration charges at the level of the investment – i.e. not requiring look through – while the guidance urges look through in most cases. We would welcome a consistent and generally permissive frame in legislation and guidance, with trustees bound by their wider fiduciary responsibilities to not indulge in cynical arbitrage; although we appreciate the DWP may wish to put some legislative guard rails on that.

Q7: Is there a risk of arbitrage? How can this be mitigated?

There is ample risk of arbitrage when it comes to look through – both intentional and accidental. Legislation and/or guidance that avoids arbitrary distinctions between functionally similar investments vis a vis look-through will considerably limit the scope of arbitrage although it is unlikely that it can be eliminated altogether.

We would like to make one general comment on the use of terminology, namely 'closed-end funds' which appears a number of times in the consultation document. While this a pertinent descriptor given the subject matter, we would caution against it becoming a synonym for structures that invest in private market assets and/or have performance fees. All the major variables and problems that we are trying to solve for could equally exist in evergreen/open-ended structures – indeed in the fullness of time we expect that most DC schemes will look to access private markets through evergreen structures.

Q8: Are there recognised industry definitions of venture capital and growth equity?

The following definitions are used in the CFA Institute's Investment Foundations program (Chapter 12 Alternative Investments p373).

> 3.1 Private Equity Strategies Private equity encompasses several strategies that may help provide money to companies at different stages of their development. The most widely used strategies are venture capital, growth equity, buyouts, and distressed. Another private equity investment strategy, which is unrelated to the stage of a company's development, is called secondaries.
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> 3.1.1 Venture Capital
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> As mentioned in the example provided in the introduction, venture capital is a private equity investment strategy that consists of financing the early stage of companies that have an innovative business idea. Venture capitalists frequently invest in "start-up" companies that exist merely as an idea or a business plan. The company may have only a few employees, have little or no revenue, and still be developing its product or business model. Entrepreneurs are often looking not only for capital to start their business but also for advice and expertise about how to establish and run their company. Venture capital is considered the riskiest type of private equity investment strategy because many more companies fail than succeed. It can take many years before a company becomes successful, and most venture capital–funded companies have years of unprofitable activity before they reach the point of making money. So, venture capital investing requires patience. However, those companies that do succeed tend to greatly reward their investors.

3.1.2 Growth Equity

Growth equity is a private equity investment strategy that usually focuses on financing companies with proven business models, good customer bases, and positive cash flows or profits. These companies often have opportunities to grow by adding new production facilities or by making acquisitions, but they do not generate sufficient cash flows from their operations to support their growth plans. By providing additional money in return for equity of the company, growth equity investors help these companies expand and become more established. Some growth equity investors specialise in helping companies prepare for an initial public offering. These investors provide additional money at a later stage of a company's development than venture capitalists or early-stage growth equity investors. As discussed in the Equity Securities chapter, additional equity dilutes existing shareholders' ownership because there are more investors sharing the company's cash flows. However, because the later-stage growth equity investors typically have expertise in organising initial public offerings, they may bring benefits that outweigh the disadvantages of dilution. An initial public offering, such as those of Microsoft, Private Equity 374 Google, and Facebook, is an opportunity for founders and existing shareholders to convert some or all of their investment in the company into cash. So, the late addition of equity investors that have successful track records in organising initial public offerings may be valuable for founders and existing shareholders.

While we understand the impetus behind focusing on VC/GE in this consultation, we think the DWP and government should not seek to prescribe certain types of investments for pension schemes and look to develop regulations that work widely for schemes and asset classes

Q9: Are there any other proposals that the government should consider to allow greater investment in venture capital or growth equity?

As noted above, we believe this charge cap consultation and the LTAF programme have the potential to make a considerable difference to how DC schemes consider and invest in private markets including VC/GE.