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Dear Andrew and Des,

RE: Investment Association Response to DWP consultation on 'Enabling Investment in Productive Finance'

The Investment Association[1] (IA) welcomes the opportunity to respond to the DWP's consultation on removing performance fees from the charge cap. It is important that DC schemes can build investment portfolios capable of delivering the best outcomes for their members and deliver the long-term investment that the economy requires. This includes being able to access asset classes whose charging structures may be more challenging to fit within the current charge cap regime. We therefore welcome the proposals set out in this consultation to remove performance fees from the scope of the cap.

We have a number of comments on the proposals:

1. Removing performance fees from the scope of the charge cap creates a more coherent charging framework. Performance fees are in essence a form of profit-sharing arrangement, which can strengthen the alignment of interests between investment managers and investors. Since they only arise where a manager has delivered outperformance for the investor, capping them has no economic rationale and creates unnecessary constraints and complexity for DC decision-makers. Reversing this position creates a more coherent charging structure for DC schemes wishing to use performance fees. We have previously set out our

[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage over £9.4trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. That is 13% of the £75 trillion global assets under management.

support for removing performance fees from the charge cap in our responses to earlier DWP consultations[2] in this area.

2. Removing performance fees from the charge cap is a necessary condition for DC schemes to invest in some private assets. Charge structures should be a matter of negotiation in the market, particularly in asset classes and strategies such as venture capital and private equity where there may be capacity constraints. Investment managers manage money on a global basis and DC schemes may be competing against other investors who are willing to pay the fees that are set by the market. Being constrained by an inability to pay performance fees could see DC schemes unable to invest in these strategies, thus missing out on the return and diversification benefits that they offer. Freeing DC schemes to pay performance fees where they choose will alleviate this risk.

3. DWP should implement the proposal in a principles-based manner, with the market left to design specific performance fee structures. The policy should be implemented by simply defining performance fees[3] and then excluding them from the scope of the cap[4]. We do not think it is desirable for regulation to contain any prescription around the parameters of performance fees, such as hurdle rates, accrual methodologies or any of the other parameters set out in paragraph 55 of the consultation. Attempting to regulate to this level of detail will create complexity for DC schemes and will almost certainly lead to unforeseen consequences that could deter investment in the relevant asset classes. For example, if a particular fund with a range of domestic and/or international investors has a specific fee structure not accommodated within the DWP prescription, it would be unrealistic to expect the fund to change to accommodate a specific set of UK clients.

Instead, the DWP and TPR should create guidance in this area that trustees can follow when assessing whether particular performance fee structures are appropriate for their schemes. In doing this DWP and TPR can draw on existing regulatory guidance on good practice around the use of performance fees in investment funds. For example, the European Securities and Markets Authority (ESMA) guidelines on performance fees[5] or the work done by The International Organisation of Securities Commissions (IOSCO) in 2016 on good practice in relation to fees and expenses for collective investment vehicles[6].

These guidelines provide principles-based examples around the application of performance fees and highlight a number of important features that performance fees should respect, notably: the principle of equitable treatment of investors; that they should be consistent with the objectives of the investment strategy and not designed to encourage managers to

[2] IA response to the 2020 DWP call for evidence on the review of the charge cap; IA response to 2021 DWP consultation on incorporating performance fees within the charge cap.
[3] FCA rules in COLL 6.7.6G define performance fees that apply to UK UCITS and NURS funds. DWP could build on this definition to implement its policy.
[4] We agree with the DWP that a corollary of this policy is that the existing smoothing mechanism and pro-rating easement can be removed from the regulations on the grounds that they would be redundant.
[5] Final report: Guidelines on performance fees in UCITS and certain types of AIF, ESMA, 2020.
[6] Good practice for fees and expenses of collective investment schemes, IOSCO, 2016. See p7-10 on performance fees.

take excessive risk with the aim of increasing their own remuneration; that fees levied are proportionate and allow investors to maintain an adequate share of their returns; and that investors are adequately informed of the fee and how it might impact their investment.

4. The exemption of performance fees should be broad and not limited to specific asset classes or investment strategies. This will ensure that DC schemes have the flexibility to consider the broadest range of asset classes when creating portfolios on behalf of their members. It is not clear why certain asset classes should have a privileged position in regulation. Venture Capital and Private Equity could have a role to play over time in DC portfolios, but no more so than public equities, private credit, real estate, or infrastructure, for example.

Trustees should have the flexibility to align their portfolios with emerging opportunities and risk-mitigation strategies and this should encompass a wide range of asset classes. To take a specific example, in the context of managing climate risk and aiding the energy transition, allocations to renewable infrastructure and natural capital could be beneficial. The management of these asset classes typically attracts performance fees. If they were excluded from a list of exempt asset classes, they would be more challenging for DC schemes to invest in.

We see no rationale in investment theory for giving preferential treatment to particular asset classes and management styles. It may skew scheme investment decisions and also gives a commercial advantage to managers offering strategies based on those asset classes. We do not believe regulation should be designed to benefit some firms at the expense of others.

There are practical challenges here as well: how should particular asset classes be defined for the purposes of exempting them from the cap? What about a fund with a small allocation to an exempt asset class? Would a proportion of its performance fee be exempted from the cap? These kinds of perimeter issues are often hard to solve and introduce further complexity, all of which create further barriers to DC schemes making allocations.

5. Trustees' fiduciary duty and full disclosure of performance fees will ensure members are protected from poorly designed fee structures. The proposal is permissive and trustees' fiduciary duty means they will only make use of the exemption if they believe that investment in asset classes with performance fees will deliver a better member outcome on a risk-adjusted basis. This will include a consideration of all fees and transaction costs associated with the strategy, alongside the expected benefits, and ex-post, the performance delivered. Key to trustees being able to carry out their function in this regard is full disclosure of performance fees, alongside the other fees and costs of the scheme's investment strategy. We therefore support disclosure of performance fees to be required and agree that publication in the Chair's statement is an appropriate place for this disclosure.

We do not believe that an exemption of performance fees from the cap will lead to the re-pricing of existing strategies and an increase in fees. DC schemes and their advisers are professional and sophisticated buyers of investment services and will not oversee shifts to performance fees at a higher level on existing strategies. Investment managers are similarly aware of pricing dynamics in the UK DC market, and we do not expect to see any 'gaming' of the regulation along the lines described by DWP in the consultation. Indeed, we fully expect the DC investment market to continue to compete strongly on price. The benefit of the measures in this consultation is that they have the potential to help shift the focus to member outcomes and value, in line with the recommendations of the Productive Finance Working Group.[7]

<u>6. We encourage the DWP to proceed quickly with implementing this policy change</u>. This is a permissive measure which schemes are free to make use of if they choose. For those schemes that do not wish to use performance fees, the measure can be safely ignored. There is no reason for its implementation to be delayed. For investment managers seeking to offer private asset strategies to DC schemes, certainty over the direction of travel is important and an expeditious implementation is therefore desirable. With the introduction of the new Long-Term Asset Fund regime[8] last November, there is real momentum for new illiquid strategies to be brought to the DC market. Certainty over the status of performance fees with respect to the charge cap will aid firms in bringing their products to market as quickly as practicably possible.

I would be delighted to discuss these comments further if helpful.

Yours Sincerely,

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

[7] A roadmap for increasing productive finance investment, Productive Finance Working Group, 2021.
[8] COLL 15 Long term asset funds