

# Government's push to facilitate investment by DC pension scheme trustees in illiquids continues as DWP consults on removing performance fees from charge cap on default DC funds

**Pensions analysis:** In a further push to enable the trustees of defined contribution (DC) pension schemes to access illiquid markets, the government is consulting on the removal of performance-based fees from the charge cap. The proposals follow reforms made last year to establish a smoothing mechanism on performance fees. Some key details, such as the applicable definition of performance fees, require further refinement and will be considered in light of the consultation responses. David James, partner, and Emily Collett, trainee solicitor, at Travers Smith examine the consultation and its implications.

This analysis was first published on Lexis®PSL on 4 January 2022 and can be found [here](#) (subscription required).

## What is the background to the consultation?

The [consultation](#) states that the government is committed to doing all it can to ensure that the trustees of occupational DC pension schemes are able to take advantage of long-term, illiquid investment opportunities where they feel they are in members' best interests. The consultation states that the government will continue to look at ways to remove structural barriers that currently prevent DC pension plan trustees from doing this, and that the government wants to ensure that the current protections in place to protect members from high and unfair charges are not diluted.

The consultation comes as part of a wider policy objective by the government to support investment opportunities in productive finance for the benefit of the wider economy, funding growth and innovation.

The consultation acknowledges that traditionally pension schemes have tended to dedicate the majority of their investment portfolio to public markets, such as listed equities and bonds, and that as the DC market matures, some trustees are looking to access a more diverse portfolio of assets, including illiquid assets, that have the potential of even greater returns.

The interrelationship between the charge cap and the performance fee attached to some illiquid investments, such as venture capital and private equity, is perceived to be one of the structural barriers that is currently preventing schemes from accessing these investments.

Since 2015, default funds of DC schemes used for automatic enrolment have been subject to a regulatory charge cap that, broadly speaking, prevents schemes from imposing charges of more than 0.75% annually of a member's pot. In September 2021, legislation was introduced to allow for the smoothing of performance fees over multiple years but, as the consultation highlights, the current legislative framework has been criticised for failing to go far enough to facilitate investment in illiquid assets.

In the 2021 Budget, the Chancellor of the Exchequer announced: 'We will consult on further changes to the regulatory charge cap for pension schemes, unlocking institutional investment while protecting savers.'

In line with suggestions from the Taskforce for Innovation, Growth and Regulatory Reform, the Productive Finance Working Group and others, the government is now proposing the removal of performance fees from the charge cap.

## **What is being proposed and why?**

The government is proposing in the consultation to exempt 'well-designed performance fees that are paid when an asset manager exceeds pre-determined performance targets' from the charge cap. The consultation mentions that reforms will seek to incorporate provisions that ensure members are only required to pay fees when genuine outperformance is achieved, though the precise mechanics of how this is achieved are subject to the consultation.

The consultation proposes that performance fees would be expressly excluded from the definition of charges in the same way that transaction costs and a number of other specified costs and charges are currently excluded.

The consultation states that there may be a need to specify which asset classes the proposals will apply to, as there may be a risk that some asset managers could seek to abuse the scope of the exemption and reform their fee structures accordingly. One of the issues which the government will consider is whether to be specific about the asset classes to which the performance fee exemption would apply (namely venture capital, private equity, infrastructure and/or private credit).

There may be a need to reform the current statutory definition of 'performance fees', for example by requiring a given hurdle rate or including other restrictions on the types of performance fees which would be excluded from the charge cap. Although there is a significant variation in fee structures across the private markets, a common fee structure adopted by many closed-ended private equity funds is usually described as '2 and 20'. In such an arrangement, the fund pays a fixed annual management fee, which is often 2% but may be slightly higher or lower depending upon the size of the fund. Very broadly, and with some variation, that fee is levied on committed capital during the investment period of the fund and then on the acquisition cost of unrealised investments for the remaining life of the fund. The percentage fee may reduce in that second phase of the fund, but in any case the fee is generally not charged on the actual value of assets under management and so is not directly comparable with the fees charged in other sectors. There is then a 'carried interest' (or performance related profit share) on returns delivered, usually only when those returns have beaten a hurdle rate, commonly 8%. The industry standard rate of carried interest is 20%, but again there is some variety, especially in private capital funds that do not focus on private equity.

Under the proposals, pension schemes can also anticipate the removal of the smoothing mechanism for performance fees that was introduced in September 2021.

The government has stated that investor transparency on charges is key. The trustees of occupational DC schemes must disclose in the annual chair's statement any charges and transaction costs (insofar as they are able to do so) that members invested in the default fund incur. The government has stated that a bad outcome would be for trustees and members to end up with less transparency on fees as a result of this measure and so, if they proceed, they are proposing similar disclosure requirements for performance-based fees as those that are currently in place for transaction costs.

## **What are the implications for pension schemes and members, and what happens next?**

The consultation anticipates that the removal of performance fees from the charge cap would remove one of the barriers to trustees of DC pension schemes considering investing in illiquids. It is anticipated that trustees would be able to invest without fear that the performance fee element of any such investments may cause the scheme to be in breach of either the statutory charge cap or the (often lower) limit on charges which has been communicated to members.

It can be argued that although members may experience some drag on investment returns as a result of performance fees, any such drag could be more than offset by the additional gains that could potentially be received by members (particularly if performance fees are only permitted to kick in after a hurdle rate of return, for example 8%, has been achieved). There will, however, be a balance to be

struck between finding investments that genuinely benefit members in the long-term and safeguarding members from excessive fees where funds have performed poorly.

One of the key points to note is that the duties of trustees to take investment decisions in the best financial interests of members after taking appropriate advice will be unaffected. Trustees should only amend investment strategies if, having carefully followed their usual decision-making processes, they have decided that including a portion of illiquids with performance fees within their default investment strategy is in the best interests of members.

The government acknowledges that there are a number of other factors outside the charge cap that affect trustees' confidence to invest in illiquid assets such as a lack of scale, daily pricing, lack of suitable investment funds and, for some, a lack of belief in an illiquidity premium in prevailing market conditions. The government acknowledges that removing performance fees from the definition of charges for the purposes of the charge cap would not be a 'silver bullet', but it may help to remove one of the barriers that trustees face. A particular risk area which is worthy of further clarification is the unclear and inconsistent statements which have been made about any potential requirement to look-through investment structures for charges below the investment level.

Depending on the outcome of the consultation, which is due to close to further comments on 18 January 2022, the government may introduce regulations to come into force in October 2022 that reflect the proposed changes.

*Interviewed by Banita Kalia*

David James is a partner in the pensions team at Travers Smith. David specialises in advising trustees and sponsoring employers in relation to their occupational pension schemes. 'David is the go to for trustee boards and is considered 'technically excellent'' (Legal 500). 'He is completely on top of the legal issues and he communicates in easily digestible terms' (Chambers UK). David is a member of the Society of Pension Professionals Defined Contribution Committee, the Pensions and Lifetime Savings Association Legal Panel, the CBI Pensions Panel, the Pension Scams Industry Group and the Association of Pension Lawyers.

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